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No.'s 278-282

JOINT BRIEF FOR PETITIONERS

IN THE

Supreme Court of the United States

October Term, 1945

RECONSTRUCTION FINANCE CORPORATION, INSURANCE GROUP COMMITTEE, GUARANTY TRUST COMPANY OF NEW YORK, TRUSTEE, CENTRAL HANOVER BANK AND TRUST COMPANY, TRUSTEE, UNITED STATES TRUST COMPANY OF NEW YORK, TRUSTEE, and THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, TRUSTEE,

Petitioners,

vs.

THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY, ET AL.,

Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

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Occasional references are made to various portions of the unprinted record on file in this Court, under the following headings:

D. Ct. Pro. ——	The printed proceedings in the District Court.
Ex. ——	Exhibits introduced before the Interstate Commerce Commission.
ICC Tr. ——	The original transcript of proceedings before the Interstate Commerce Commission.
I Tr. ——	The unprinted transcript of record in the appeals from the order approving the Plan.
II Tr. ——	The unprinted transcript of record in the appeals from the order confirming the Plan.
194 — Ct. —	Exhibits introduced in the cited year before the District Court.

INTRODUCTION

"These cases involve a plan for the reorganization of a railroad under Section 77 of the Bankruptcy Act."

The railroad, known as The Denver and Rio Grande Western Railroad, lies between Denver, Colorado, and Ogden, Utah. It is shown on the map in Appendix A.

After exhaustive hearings, in proceedings that have endured for a decade, a plan was approved by the Commission and the District Court for Colorado. The Plan reduces capitalization almost to the principal and interest of the secured debts having a first lien on some part of the property (the Senior Claims), converts much of their claim into new junior bonds and stock, allots the remainder of the new common to an issue of old bonds having only a junior lien (the General Mortgage Bonds) and finds that the old unsecured debt and stock are valueless. These results were far from welcome to the holders of the Senior Claims, for their new junior securities, allotted only in a face amount equal to their claim, were not such as to assure full payment. But the procedure for shaping a plan having been fulfilled by the action of the Commission, they supported the Plan, hoping to expedite the reorganization by this compromise. Nevertheless, the General Mortgage Trustee, whose bondholders would have received nothing on a strict assertion of the rights of the Senior Claims, appealed from the District Court's confirmation of the Plan.

The issue is whether the Circuit Court erred in requiring that the Plan be changed in various particulars for the benefit of the General Mortgage Bonds.

The Petitioners, asserting that the Circuit Court erred and the orders approving and confirming the Plan should be affirmed, represent each class of Senior Claims, either as owners of substantial portions of such indebtedness or as trustees under indentures securing it. They all join in this brief. The Respondents, defending the action of the Circuit

Court, are, principally, the General Mortgage Trustee and, less importantly, the Debtor and the Missouri Pacific Trustee, the latter as a holder of the old stock.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 233-262) is reported in 150 F. 2d 28.

The opinion of the District Court approving the Plan (R. 187-206) is not reported. Its opinion confirming the Plan (R. 213-224) is reported in 62 F. S. 384.

The reports of the Commission (R. 1-186) are reported in 233 I.C.C. 515, 239 I.C.C. 583, 254 I.C.C. 5 and 254 I.C.C. 349.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on May 10, 1945 (R. 262). The petition for writs of certiorari was filed on July 30, 1945 and was granted on October 8, 1945 (R. 1201).

The jurisdiction of this Court rests on Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U.S.C., Section 347 (a)) and on Section 24 (c) of the Bankruptcy Act (11 U.S.C., Section 47 (c)).

QUESTIONS PRESENTED

1. *Distribution of cash on hand (p. 37 below):* Whether the Circuit Court was free to require a distribution of the cash on hand in a method counter to the provisions of the Plan.

2. *Distribution of future earnings (p. 55 below):* Whether the Circuit Court was free to require the creation of additional new junior securities, contrary to the provisions of the Plan, because of its own view of future

earnings, and to require the allocation of those securities to the General Mortgage Bonds.

3. *Equipment trust obligations and Junction Bonds (p. 82 below)*: Whether the Circuit Court was free to require the creation of additional new senior securities, contrary to the provisions of the Plan, because of the use of cash on hand after the stated effective date of the Plan to pay or purchase old senior debt, and to distribute additional value on that account to the General Mortgage Bonds.

4. *Utah Fuel Stock (p. 89 below)*: Whether the Circuit Court may require that the value of collateral pledged for obligations of the Debtor but owned by others must be deducted from the pledgees' claim before they can receive any new securities under the Plan.

5. *Power to confirm over a dissent (p. 100 below)*: Whether the Circuit Court was right in holding that the dissent of the General Mortgage Bonds precluded confirmation of the Plan.

STATUTE INVOLVED

The pertinent provisions of Section 77 are set out in Appendix B.

STATEMENT

1. Background of the Business Problem

A year after the golden spike near Ogden, Utah, completed the first transcontinental railway line in 1869, the first predecessor of the Debtor was incorporated.[1] It started building a railroad south from Denver to the Rio Grande River.[2] But obtaining passage through the Royal Gorge, it turned west into the fastnesses of the Rocky Mountains. At this time the road was narrow gauge. Its business was to serve the local lumbering and mining operations. But in 1890 one of its routes was changed to standard gauge and in 1901 it acquired control of a western connection to Salt Lake City and Ogden.[3] These events opened its way for transcontinental freight.

There are three main routes for transcontinental freight. The northern route is served by the Great Northern, the Northern Pacific and the Milwaukee. The central route is served by the Union Pacific and the Rio Grande. The southern route is served by the Santa Fe and the Southern Pacific (I Tr. 4395, 4399). The nearest competitors of the Rio Grande are the Union Pacific on the north, strongly entrenched in its strategic "Overland Route", and the Santa Fe on the south, with its through lines from Chicago to the Coast.

It was recognized at an early date that the Rio Grande could not live by local business alone, but must depend on

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[1] These historical matters appear in the Bureau of Valuation Report (I Tr. 832) and R. 250, n. 7; Ex.'s 136-7; and *Denver and Rio Grande Railroad Company*, 26 Val. Rep. 733 (1929).

[2] Hence its name, Denver and Rio Grande Railway Company reorganized in 1886 as The Denver and Rio Grande Railroad Company.

[3] The Rio Grande Western Railway Company, itself a successor in reorganization. The two companies were consolidated in 1908.

a substantial share of the highly competitive transcontinental freight. This was dramatized by its desperate commitment in 1905 for the construction of the Western Pacific in order to have its own friendly connections from Salt Lake to the Coast when control of its other western connections was acquired by the wealthy Union Pacific.[1] Though this commitment led to a receivership of the Rio Grande in 1920, in which it lost control of the Western Pacific, the economic fact remained. It has, indeed, grown still more urgent. In 1920 over 80% of the total tons carried by the Rio Grande originated on its own lines and only 7% was overhead business, that is, traffic received from one connecting road and delivered to another connecting road in a through movement.[2] By 1940 originated business had shrunk to 37% of total tons, while overhead business had grown to 25%.[3] This shift occurred in the face of a relatively static volume of total business.[4] As the District Court said of the overhead business,

> "Without this business, this railroad could not begin to support a capital structure of any size." (R. 203)

This fact is of critical importance in any judgment of the road's future. Its consequences ramify widely, but two stand out above the others.

One of these is the level of rates. Long-haul transcontinental freight carries a lower rate per ton mile than local freight (R. 850). So the decline in rate levels, in itself a

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[1] R. 533-536.

[2] Ex. 272, R. 1138.

[3] The percentage of overhead business to total business has, of course, sharply increased in the war years (R. 203), but the conditions of those years are too abnormal for use as a guide.

[4] The war years are, of course, an exception.

general trend of the railroad industry since 1921,[9] is accentuated as the proportion of transcontinental freight increases. Thus the average revenue per ton mile on the Rio Grande, which is "the basic index of the gross yield from transportation service" (R. 218), declined nearly 50% between 1921 and 1940, and the average revenue per passenger mile followed a similar course.[10] That means that the Rio Grande now has to perform nearly twice as much transportation service in order to obtain the same revenue as in 1921. The reduction from 1929 to 1940 was about 25% in freight rates, and more for passenger.[11]

The other outstanding result of increasing dependence on overhead business is the standard of service it necessitates. Though receiving less than before, the Rio Grande has had to provide more than before, or lose the business. The fierce competition for this traffic leaves no place for inferior service, as the Circuit Court had already observed in another connection.[12] Above all, this has required progressively faster schedules.

The physical situation of the road has always presented unusual difficulties to this development. It traverses one of the wildest mountain areas in the country. It threads through precipitous canyons that are periodically flooded by ungovernable torrents, tunnels under impassable peaks and surmounts the continental divide at 10,000 feet above sea level.[13] Its time tables aptly proclaim the "Scenic Line

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[9]Moulton and Associates, *The American Transportation Problem*, (1933) p. 113.

[10]Annual Reports, 1936 p. 27 and 1940 p. 27. The war years show a slight increase above 1940. (Annual Report, 1944 p. 29)

[11]Annual Report, 1944 p. 29.

[12]*Van Schaick* v. *McCarthy*, 116 F. 2d 987, 991, 993 (C.C.A. 10, 1941).

[13]Ex.'s 130-134 and 162.

of the World," running "Thru the Rockies—not around them."

In these circumstances the need for keeping step with current advances in the art of railroading has required huge expenditures through a long period of years. In the twenties, when the railroad industry made such large improvements to its physical plant,[13] the Rio Grande spent 40 million dollars on improvements, three-fourths of which was chargeable to capital.[14] Yet the Debtor entered the bankruptcy court in 1935 with its property starved by undermaintenance.[15] In the course of this proceeding the District Court has made up that deficiency and carried out another huge improvement program, disbursing 43 million dollars chargeable to capital and 10 million dollars chargeable to operating expenses in connection with improvements.[16]

There can be no doubt that the revolutionary changes in railroad service and facilities that impend, as a result of the accelerated technological advances of war-time and the intensified competition to result from the restoration of unlimited service by sea, air and highway, will necessitate further improvements. The District Court looks forward in these terms:

> "It is suggested by competent railroad authorities that the only solution for the American railroads in the coming post-war competition is to build super-railroads to meet this competition. Great improvement in

[13] Over 5 billion dollars in the period 1919-1929, though freight traffic increased only 10% and passenger traffic declined (Moulton and Associates, *The American Transportation Problem*, (1933) pp. 42 and 45).

[14] R. 738-9 and I.C.C. Tr. 807-16 (I. Tr. 2286-95).

[15] R. 534, 537, 195 and 221.

[16] R. 195 and Annual Reports, 1935-1944.

railroad plants and equipment will be required, together with many technical improvements—all at a very large cost." (R. 206).

In meeting these demands in the past the Rio Grande has been handicapped by excessive and unsuitable capitalization, which has forced repeated resort to the courts, four times indeed to the District Court below.[11] The company owning the Colorado properties was created in the reorganization of a predecessor. So was the company owning the Utah properties. The company resulting from their consolidation in 1908 went into receivership in the District Court below in 1918, upon enforcement of its Western Pacific guaranty. But only the old stock was eliminated, and the properties were conveyed to the Debtor (newly organized in Delaware for that purpose) subject to all the unwieldy bonded debt of the old company. In 1922 the Debtor was back in the District Court for further reorganization. All the old securities were carried forward. The only change was to convert two junior system issues of bonds into an equal amount of new General Mortgage Bonds (those in controversy here) and new Preferred Stock, both subject to a new system mortgage for further issues of debt. There has never been a dividend on the stock of either class, and the stipulated interest on the General Mortgage Bonds was paid for only four years.[12] Financing was wholly by bonds issued

[11]The American railways as a whole anticipate capital expenditures of 1,636 million dollars in the first three years after the war (Interstate Commerce Commission, Bureau of Transport Economics and Statistics, Monthly Comment on Transportation Statistics, Dec. 10, 1945). Intensified "competition within and among the several forms of transportation" is expected to be the "keynote of the postwar years" (59th Annual Report of the Interstate Commerce Commission, Nov. 1, 1945, p. 7).

[12]R. 539.

[13]Interest for the first 5 years (to February 1, 1929) was contingent on the needs of the property. In March, 1934, the Debtor proposed an interest adjustment plan (Ex. 43, 1 Tr. 3479).

under the new system mortgage and, later, by collateral notes. Beset in 1935 by a reduced traffic volume and the incipient rise in cost levels, the Debtor returned to the District Court like a homing pigeon.

But this rise in unit costs of operation did not pass off like a summer storm. It has continued relentlessly and is still in progress, thus raising a serious question as to future net earning capacity, on which we comment in the Argument below.

Such is the broad perspective in which the Commission addressed itself to its statutory function of determining a new capital structure realistically adapted to the earning capacity of the road and capable of serving its needs in adequate service to the public during the good years and bad of the long future.

2. The Properties

The Rio Grande lines may be thought of, simply, as a large Y, lying on its side across the Rocky Mountains (Appendix A). Its foot lies to the west at Salt Lake City and Ogden, where connection is made with the Western Pacific and other roads to the Coast. The right or southern arm ends at Pueblo, Colorado, where connection is made with the Missouri Pacific. That is the original line. The left or northern arm was developed just before bankruptcy to provide a new short route to other connections at Denver for the east, thus improving the competitive position for transcontinental traffic. It is not owned directly by the Rio Grande, but as stated below. Traffic moves over the two arms in approximately equal volume.

The greater part of the northern arm is owned by The Denver and Salt Lake Railway Company (the Salt Lake). A short connecting link is owned by The Denver and Salt Lake Western Railroad Company (the Salt Lake West-

ern).[20] The former was an independent road, reorganized in 1927 with a large bonded debt of its own,[21] and is not now in reorganization proceedings. Most of its stock was acquired by the Debtor shortly before bankruptcy, by means of an RFC loan for which the stock is pledged as collateral. The Rio Grande operates over that line pursuant to a Trackage Contract.[22] The Salt Lake Western is a petitioning debtor in this proceeding. Its line was built a short time before bankruptcy, by means of another RFC loan, for which all its stock is pledged as collateral. Its line is operated by the Rio Grande under a Lease.[23] Both the Trackage Agreement and the Lease have been affirmed by the District Court.[24]

The details of these relationships are not significant for present purposes, but their broad outline is, for the Rio Grande must pay to maintain its through route over the northern arm. If the holders of the Salt Lake Income Bonds consent to the modifications of their position proposed in the Plan, the Plan provides that the Salt Lake and the Salt Lake Western are to be consolidated with the Rio Grande, thus increasing the new bonds by 22 million dollars (at the same time reducing the new stock and eliminating the present Salt Lake and Salt Lake Western stock), though the Commission found that the increase in value of the system for the purposes of this proceeding because of including the Salt Lake and Salt Lake Western was only 11.6 million dollars (R. 159). Without such consent, there will be no consolidation, but the Rio Grande will con-

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[20]This line runs from Dotsero to Orestod, 38 miles (R. 32), and is called the Dotsero Cut-off.

[21]$2,000,000 of First Mortgage Bonds and $11,000,000 of Income Mortgage Bonds.

[22]Ex. 12, 1 Tr. 2684.

[23]Ex. 12, 1 Tr. 2791.

[24]R. 631.

tinue liable under the Trackage Contract and the Lease. The annual payments required under those two instruments total something over a million dollars, which do not appear in a statement of new fixed charges, but must be met nonetheless.[27] The Plan is discussed here on an unconsolidated basis, since that makes an adequate, and simpler, presentation.

3. Present Capitalization

Present capitalization, so far as need be considered here, may be resolved into two groups of claims: on the one hand, various issues of secured indebtedness having a first lien on some part of the property (referred to collectively as the Senior Claims or Senior Creditors, for no issues among them are presented here), and, on the other hand, the General Mortgage Bonds, being the most junior lien on the property and the most junior claim recognized in the Plan. Each class of the former is represented here by the parties to this brief, as substantial owners or as indenture trustees. The latter are represented here by the General Mortgage Trustee. Beyond these are unsecured claims in a small amount and Preferred and Common Stock, all of which may be disregarded in these appeals, for the finding of the Commission that they have no value was affirmed by the District Court and approved by the Circuit Court.[28]

The amount and security of the respective issues of secured indebtedness are generally indicated in the following table, and the details, if they be of interest, are shown in Appendices C and D.

[27] R. 1092 and 631.

[28] *Allen* v. *Trust Company of Georgia*, —— U. S. —— (1946); *Tennessee Coal Iron & R.* v. *Muscoda Local*, 321 U. S. 590, 605, conc. op. (1944); *U. S.* v. *O'Donnell*, 303 U. S. 501, 508 (1938); *National Licorice Co.* v. *N.L.R.B.*, 309 U. S. 350, 357 (1940). The Debtor and the Missouri Pacific Trustee petitioned for writs of certiorari on those issues, but their petitions have not been granted or denied.

Issue	*Lien*	*Amount* (in millions of dollars, principal and interest to the effective date of the Plan on January 1, 1943)
Western Trusts	First lien on most of Utah	20
Western Consols	Second lien on the above properties and first lien on some branch lines	22
Eastern Consols	First lien on most of Colorado and some equipment	56
R&I Bonds	First lien on some equipment and some branch lines; junior lien on the above properties	35
RFC Notes	First lien on all Salt Lake Western stock, most Salt Lake stock, some of above bonds (as shown in Appendix D) and other collateral	14
Generals	Junior lien on the above physical properties	44

Finally, a short segment of the main line in Colorado is owned by a subsidiary, the Junction Company, and is subject to the first lien of 2 million dollars principal amount of Junction Bonds.[37] At the effective date of the Plan they were publicly held and are provided for in the Plan, but since that time they have been acquired by the estate and are now held by it, thus raising one of the questions dealt with below.

4. The Proceedings Below

As already indicated, the proceedings that culminated in the approval of the Plan were unusually long and thorough. This is apparent from a glance at the formidable chronology:

[37] The line runs from Rifle to Grand Junction, 62 miles (R. 32). It is operated by the Rio Grande under lease.

Hearings	*Briefs*	*Opinions*	*Date*	*Pages*
I.C.C.			1936 Oct. 20-23	2,120
I.C.C.			1937 Feb. 16-17	596
I.C.C.			1937 Apr. 13-15	608
I.C.C.			1937 June 15-18 and 23	1,719
	I.C.C.		1937 Sept.	850
		I.C.C.	1938 Aug. (Ex'r's Report)	78
	I.C.C.		1938 Oct.	503
	I.C.C.		1938 Dec. 7 (oral argument)	240
		I.C.C.	1939 July 11	79
	I.C.C.		1939 Sept.	188
	I.C.C.		1939 Nov.	229
		I.C.C.	1940 Apr. 2	30
	D. Ct.		1940 July	73
D.Ct.			1940 July 29-Aug. 12	1,822
		D. Ct.	1940 Aug. 30	4
		D. Ct.	1940 Dec. 6	35
	D.Ct.		1941 Jan. 6-8 (oral argument)	231
	D.Ct.		1941 Feb.	74
		D.Ct.	1941 Mar. 6	16
I.C.C.			1941 May 20	272
	I.C.C.		1941 July	327
		I.C.C.	1941 Aug. 26	48
	I.C.C.		1941 Oct.	320
	I.C.C.		1941 Dec. 16 (oral argument)	152
		I.C.C.	1942 July 13	42
D.Ct.			1942 Oct. 23-24	172
	I.C.C.		1942 Sept.	118
D.Ct.			1943 Apr. 14-16	340
		I.C.C.	1943 June 14	56
			Total	11,342[25]

[25] In addition to documentary evidence before the Commission and 19,462 pages of printed proceedings in the District Court (only to August 2, 1943, but involving some duplications of the material listed above).

Thereafter the Plan was approved and confirmed by the District Court, and its orders reversed by the Circuit Court, as shown in the following table:

Tribunal	*Proceeding*	*Date*
D. Ct.	Hearing on approval	Sept. 13-15, 1943
D. Ct.	Opinion (R. 187) and order (R. 207) approving Plan	Oct. 25, 1943
D. Ct.	Appeal to C.C.A. by Debtor	Nov. 24, 1943
I.C.C.	Submission of the Plan to creditors	April 26, 1944
I.C.C.	Report to D. Ct. that Plan had been accepted by all voting classes except Generals[2]	July 4, 1944
D. Ct.	Hearing on confirmation	Aug. 30-31, 1944
D. Ct.	Opinion confirming Plan (R. 213)	Nov. 1, 1944
D. Ct.	Order confirming Plan (R. 224)	Nov. 29, 1944
D. Ct.	Appeal to C.C.A. by General Mortgage Trustee, Debtor and Missouri Pacific Trustee	December, 1944
C.C.A.	Oral argument in first appeal	Nov. 13, 1944
C.C.A.	Oral argument in all appeals	March 14, 1945
C.C.A.	Opinion (R. 233) and order (R. 262) reversing District Court	May 10, 1945
S. Ct.	Writs of certiorari granted	Oct. 8, 1945

[2] R. 265. The figures for the General Mortgage Bonds were 21.5% voting and of those 79.3% dissenting.

5. The Record Before the Commission

The record developed before the Commission in these lengthy proceedings is a complete one. It includes elaborate evidence on each of the various subjects that were mentioned by this Court in *Ecker* v. *Western Pacific R. Corp.*, 318 U. S. 448 (1943),[30] as pertinent to a determination of reorganization value and the permissible amount of new capitalization. Specific applications of the evidence to the questions presented here will be noted later in the discussion of those questions. Its general scope is sufficiently epitomized by the following references:

1. *History of the System.*—Covered by an encyclopaedic report of the Bureau of Valuation (I Tr. 832) and illuminated in detail by a great mass of historical and corporate documents, as well as by the statistical material in the Annual Reports.

2. *Characteristics and Condition of the Properties.*—Shown exhaustively from many points of view, including the location of lines;[31] the weight of rail, nature of ballast and number and character of bridges,[32] grades, elevations, alignments and tunnels.[33] Particular attention was given to the two improvement programs, one in the 'twenties[34] and the other in the course of this proceeding,[35] showing the money spent and the improvements made.

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[30]Hereinafter cited as *Western Pacific Case*.

[31]Ex. 7, I Tr. 2682, Ex. 129, I Tr. 3954 and map bound in the Annual Reports.

[32]Annual Reports at p. 39 (or 41) and next footnote below.

[33]Ex.'s 130-134, I Tr. 3955-60; Ex. 162, I Tr. 4019; Ex. 163, I Tr. 4020; ICC Tr. 1397-1403, I Tr. 2421-27; ICC Tr. 1464-74, I Tr. 2449-59.

[34]ICC Tr. 518, I Tr. 2177; ICC Tr. 807-16, I Tr. 2286-95.

[35]Ex.'s 268-70, I Tr. 4905-7. See also R. 193 and Annual Reports.

3. *Traffic Experience and Prospects.* — Analyzed at length from all points of view, including the nature of the territory served and the business originating there;[36] the physical volume of business year by year moving over the system as a whole,[37] moving over the several parts of the system[38] and interchanged with the various connecting roads;[39] the character and volume of the different classes of commodities making up that business;[40] the relative position and trend of Rio Grande business in the whole transcontinental field, as affected by the opening of the Salt Lake-Western (Dotsero Cut-Off) and the Bieber Cut-Off;[41] estimates of future physical volume of traffic by classes of commodities;[42] and recent developments of war time.[43]

4. *Operating Revenues.*—Shown year by year since 1915[44] with various analyses and explanatory comments including a statement of the average rate per ton mile and per passenger mile year by year.[45]

5. *Operating Expenses.*—Shown for the same period with equal particularity,[46] including evidence of the marked increase in unit costs of operation during recent years and showing separately the amounts paid for taxes.

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[36]ICC Tr. 101-4, I Tr. 2028-31.

[37]Annual Reports, statement entitled "Transportation Statistics", appearing usually at p. 26.

[38]Ex. 21-21d, I Tr. 2830-34; 1940 Ct. Guaranty Trust Ex. 2, I Tr. 4689; 1940 Ct. R. & I. Ex. 2, I Tr. 4715.

[39]Ex. 23, I Tr. 2836 A; ICC Tr. 40-42, I Tr. 1978-80.

[40]Annual Reports, statement entitled "Classification of Freight Tonnage", appearing usually at p. 21.

[41]R. 949-52.

[42]R. 742-51; Ex.'s 118-120, R. 1104-08.

[43]R. 1016-17.

[44]Annual Reports.

[45]See *id.*, statement entitled "Revenue Statistics", appearing usually at p. 29.

[46]*Id.*, statement entitled "Expense Statistics", appearing usually on pp. 30-31.

6. *Net Earnings Available for Return on Securities.*—Shown year by year for the same period;[47] and estimated for the future normal year.[48] This period covered the whole of the prosperous 'twenties, the whole of the austere 'thirties and the most dazzling of the war-time years, 1942. By aid of that year's lower stage in the rising spiral of costs and a large income tax deduction for previous losses, the Rio Grande derived from the extraordinary war-time traffic of that year much greater net earnings than at any other time before or since. The period since Commission action, therefore, has not seen a further upsurge of earnings but a tapering off of the extraordinary earnings of war time.

7. *Elements of Physical Value.*—The original cost of the system properties, their cost of reproduction new and less depreciation and the value of lands and rights are shown by the Bureau of Valuation Report. Balance sheets show the recorded investment and there is extensive testimony for the Debtor on reproduction costs.[49]

6. The Commission's Action

The Commission weighed all this evidence, particularly the record of earnings so far as it thought there was a reasonable likelihood of their being realized in the future. In its original reports of 1939 (R. 68, 85) and 1940 (R. 110) the Commission, noting already "the steady increase in operating expenses, taxes, and joint facility rents" (R. 44), fixed the total new capitalization at 147 million dollars for the Rio Grande and the Salt Lake on a consolidated basis.[50] This sum was smaller than the total secured debt, so the Commission held the interests of unsecured creditors and stockholders were without value.

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[47] *Id., loc. cit.*

[48] Ex.'s 118-20, R. 1104-08.

[49] R. 827-33; I Tr. 2624-47, 2658-74; R. 894-949.

[50] That plan had no alternative of non-consolidation.

When the case came back to the Commission in 1941 after disapproval of the first plan by the District Court, new evidence was received as to the large improvement work of the Debtor Trustees and the operating economies resulting from it. These circumstances, the Commission found, indicated "an increase in earning power" (R. 123). But even so, the net earnings available for interest of the combined properties in 1940, when these economies had been largely realized, or in 1941, when the accelerated pace of national defense preparations had substantially increased railroad traffic, would not, if capitalized at 5% or even at 4%, produce a total new capitalization as large as the principal of the bonds (R. 118-19), or for that matter, we may now add, as large as the amount of the Senior Claims. Consideration was also given to physical values, where the Commission found a cost of reproduction less depreciation (plus value of lands and rights, provision for working capital and net additions) aggregating 156 million dollars at December 31, 1940 (R. 122). On all this evidence, but giving special weight to earnings, the Commission raised the total new capitalization by 8 million dollars and found in terms:

> "Considering the entire record, and taking into account the elements of value of the properties involved, their past and present earnings and prospects for future earnings, as well as other pertinent factors, we conclude and find that the value of the properties [of the consolidated system] for the purposes of this proceeding is $154,521,612 and that the total capitalization upon consummation of the plan should not exceed approximately that amount" (R. 124).

This figure being less than the bonded debt, the interests of general creditors and stockholders were again found to be without value (R. 119). The Commission felt unable to allow a further increase in new capitalization as requested by the General Mortgage Trustee (R. 138). After giving

the Senior Claims a face amount of new securities equal to their total claims, there remained new Common Stock for the General's at the rate of $70 par amount per $1000 bond (report of July 13, 1942, R. 138-39).

Within the statutory period for modification petitions,[51] the General Mortgage Trustee filed a petition of August 20, 1942, in which it asked a greater allocation of Common Stock, though admitting

> "that the present excellent earnings are unpredecented and may not continue, and that they are perhaps in part the result of the extraordinary war traffic over the lines of the Debtor." (R. 614).

While this was under submission the Commission received further evidence from the District Court, taken at the hearing of October 1942 on the petition of the Senior Creditors for an interest payment (which was denied) and at the hearing of April 1943 on adoption of the Lease and Trackage Agreement (which was ordered). This included the earnings for the full year 1942 and the cash position at the year end, in addition to evidence of further improvement work. Current financial statements and other material filed with the District Court were always before the Commission by stipulation.[52] On this record the Commission found (report of June 14, 1943) that

> "The present cash position and earning power of the Denver are adequate assurance that any probable amount of cash required for paying the remaining reorganization expenses and the refunding or payment of nonassenting Salt Lake bonds can be met from funds on hand." (R. 155)

In view of this the Commission cancelled a provision in its 1942 plan for new money for these purposes and payment

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[51] Section 77(d), last paragraph.

[52] R. 661, 789, 879.

of Trustees' certificates (actually paid later that year), and was thus able to increase the Generals' allocation to $146 par amount of new Common per $1000 bond (R. 155 and 163), or slightly more than double the previous allocation. It found, however, that there should be no further increase in new capitalization (R. 162), remarking that:

> "The debtor's earnings in 1942 are recognized, but the uncertainties surrounding the economic situation negative any assurance of a long continuation of such earning power." (R. 158-9)

The Commission thus reaffirmed its previous findings of value and permissible new capitalization:

> "After consideration of the foregoing and all the information of record, we conclude that the value of the combined properties [including the Salt Lake and Salt Lake Western] for the purposes of this proceeding is approximately $155,173,127 and that the capitalization of the reorganized system should not exceed approximately that amount.
>
> ". . . The resulting new total capitalization of the Denver [excluding the Salt Lake and Salt Lake Western] would be substantially $143,528,027. . .
>
> "We find that . . . the value of the combined properties for the purposes of this proceeding, excluding the Salt Lake and Salt Lake Western, is approximately $143,528,027." (R. 159)

The Commission accordingly approved the Plan (June 14, 1943, R. 1, 151).

7. Terms of the Plan

The details of the new capitalization may be found in Appendix E. As for allocations, RFC receives, in the event of consolidation with the Salt Lake and Salt Lake Western,

37.41% of its claim in new First Mortgage Bonds and the remainder in new Income Bonds, or, in the absence of consolidation, a new escrow note for the amount of its claim, secured by the Salt Lake and Salt Lake Western securities (and certain other collateral) now held in pledge and by the new securities issuable for the pledged Rio Grande bonds. The underlying Rio Grande bonds receive, with or without consolidation, new securities in the following percentages of their total claim as of the stated effective date of the Plan on January 1, 1943:

	First's	Income's	Preferred	Common
Western Trusts	73.5	26.5		
Western Consols		20.0	73.0	7.0
Eastern Consols	23.8	16.2	24.0	36.0
R. & I's	17.7	11.3	22.0	49.0

As stated above the Generals receive $146 par amount of new Common per $1000 bond (aggregating 10% of all the issued Common) and, as before, the interests of unsecured creditors and stockholders are found to be without value.

8. The District Court's Action

Before the District Court the General Mortgage Trustee renewed its argument that the new Common Stock issue should be increased and the whole of the increase be given to the General's (I Tr. 5280). The court, however, rejected this argument and approved the Plan. In its opinion the court stressed the competitive necessities of the property (R. 190), paralleled as it is by the Union Pacific on the north and the Santa Fe and Southern Pacific on the south (R. 204), necessities that are certainly not reduced by its increasing dependence on transcontinental business (R. 203-4) or made lighter by the exceptional severity of its operating conditions (R. 197). The huge expenditures during

the proceeding had made up the deferred maintenance of 1935 and "placed the property for the first time in a competitive position with other transcontinental carriers" (R. 196). But further improvements would be needed (R. 195-6, 197, 206). War earnings, the court found, were "inflated" (R. 192), 60% or more of passenger and freight business being due to the war effort:

> "It would, therefore, seem that very little, if any, of these inflated earnings are sufficiently permanent to form a basis for additional securities." (R. 194)

The court concluded that:

> "there is sufficient evidence to support the findings of the Commission, and . . . legal standards have been followed." (R. 203)

So it approved the Plan (R. 206).

Before the Commission an argument had been made that since the Junction Company, owning, as said above, 62 miles of the main line in Colorado (which are leased to the Debtor), was not a petitioner in any Section 77 proceeding, its 2 million of outstanding bonds were not subject to modification in bankruptcy. The Commission provided new bonds in the Plan for this issue but desired to avoid any delay because of the Junction situation in the accomplishment of the rest of the Plan (R. 166). So it authorized the District Court, if helpful to avoid delay, to terminate the provisions of the Plan as to the Junction and carry out the rest of the Plan as written, the stock and lease of the Junction in that event to become assets of the reorganized company (R. 2, 166). The same contention, and others of a complicated nature, arose before the District Court at the hearing on approval of the Plan. In this state of affairs the court, quoting the above provision of the Plan and a further provision authorizing the court to construe and to cure defects, directed the Debtor

Trustees to purchase the Junction Bonds out of "the excess cash" then on hand, remarking that there was an amount "that it is not necessary to carry forward into the reorganization" (R. 200; 262). Pursuant to this order (R. 264), the Junction Bonds were acquired by the estate at a cost of about $2,750,000 (R. 277) and are now held by it.

After the entry of the order approving the Plan on October 25, 1943 (R. 207), the Commission submitted the Plan to creditors for their acceptance or rejection and in July, 1944, certified the results to the District Court (R. 265). The Plan was accepted by all voting classes except the General Mortgage Bonds, which rejected it by a large proportion (79.3%) of the small minority that voted (21.5%).

A hearing was held before the District Court on August 30-31, 1944 on the question of confirming the Plan. The General Mortgage Trustee now urged:

(*i*) that the $2,750,000 of new bonds provided in the Plan for the Junction Bonds, by this time held by the estate, be redistributed among the Senior Claims and that an equal face amount of new Common Stock be transferred from the Senior Claims to the General's (R. 346-47, 645, 648-9);

(*ii*) that the new Common Stock issue be increased to provide a greater allotment for the General's (R. 647); and

(*iii*) that cash on hand should be distributed in payment of interest recognized in the Plan on Senior Claims, and an equal amount of new Common Stock be transferred from the Senior Claims to the General's (R. 646, 648-9).

The court denied all these motions and confirmed the Plan.

On the first point the court felt it did not have the power to make the requested redistribution because it would, in effect, change all the allocations in the Plan (R. 217). Considering the merits, however, it relied (*a*) on the fact that:

> ". . . the court in its treatment of the Junction Bonds did not pay off a debt, but only purchased securites, thereby giving the debtor control of another railroad property, to-wit, the Rio Grande Junction Railroad Company—a necessary part of its system" (R. 216);

and (*b*) on the provision of the Plan that the new capitalization should be

> ". . . subject to reduction . . . as equipment obligations or other liabilities are paid or reduced." (R. 217)

On the second point the court felt that the past history of the property left no possibility of an increase in new capitalization (R. 218). The earnings of war years, it emphasized, were abnormally inflated, 60% of gross revenues being due to war business (R. 220). This resulted not only from "the tremendous increase in total transcontinental traffic due to the war in the Pacific," but to virtual elimination of competition from other agencies of transport (R. 219). These benefits were accentuated by the more even flow of traffic occasioned by the heavier westbound tonnage of war-time, which overcame the operating handicaps of normally predominant eastbound tonnage (R. 219). All three circumstances were temporary and would end with war conditions (R. 219). The new industries of war-time in the territory were closing, except two (R. 220). Looking, then, to the long future, the court properly gave weight to two fundamental factors, "the steady and material reduction in average revenues per ton mile" and the "very large increases in operating expenses . . . greatly increased operating costs, such as wages, fuel, materials and supplies of

all kinds" (R. 218). Most significantly, the court found that these increases were of such extent as "more than offsets the economies effected by the Improvement Program" (R. 218-219). In conclusion the court felt that the new Common Stock "has little or no value" (R. 220), or if any, then wholly because of the improvement work and increase of current assets (R. 222).

The objection of the General Mortgage Trustee that cash should be distributed before the Plan could be confirmed was not pressed in oral argument, or separately dealt with in the opinion, but was overruled, with all other objections, in the order that was entered confirming the Plan (R. 224).

9. The Circuit Court's Action

The Circuit Court reversed the orders approving and confirming the Plan. One judge concurred only in result, with a separate opinion which is principally an attack on prospective earning capacity as a criterion of reorganization value (R. 254).[32] We think no further comment on that opinion necessary.

The majority opinion falls into two distinct parts, what it said, and what it did. In the former, the court concluded that the Commission had proceeded properly in setting up the new capital structure and its action in that regard must be upheld. In the latter, the court required important changes in that capital structure.

As for what it said, the court agreed with the Commis-

[32] Attention had been invited to the decisions of this Court establishing that criterion as a cornerstone of reorganization law (*e. g.*: *Consolidated Rock Products Co.* v. *DuBois*, 213 U. S. 510, 525-6 (1941); *Western Pacific Case*, 318 U. S. at 483; *Group of Institutional Investors* v. *Chicago, Milwaukee, St. Paul & Pacific R.*, 318 U. S. 523, 539-41 (1943) [hereinafter cited as *Milwaukee Case*]) and to previous opinions of the same judge approving the same criterion in equity practice (*Teinmer* v. *Denver Tramway Co.*, 18 F. 2d 226, 229 (C.C.A. 8, 1927); *New York Trust Co.* v. *Continental & Commercial Trust & Savings Bank*, 26 F. 2d 872, 874 (C.C.A. 8, 1928)).

sion and the District Court that the earnings of war-time were "abnormal" and "inflated," saying:

> "These earnings are to a great extent artificial, and will disappear largely with the coming of the peace. They have very little value in estimating the probable future earnings of this property in the peace economy which is to come." (R. 242).

Moreover, it was "in the outer realm of speculation" what revenue, if any, might be derived after the war from industries opened in the territory during the war, and the Commission did not err in failing to give greater recognition to these possibilities (R. 242). Prospective earning capacity is a proper criterion of reorganization value, indeed "the only method which can insure the continued operation of a railroad without recurring receiverships" (R. 241) and that criterion was properly applied by the Commission to a long period of years, including not only depression years but normal years and abnormal war years as well (R. 242). Nor did the Commission err in refusing to increase its 1939 figure for permissible amount of new capitalization by the full amount of intervening improvements to the property: the question still was how much the enterprise could probably earn in the future; operating costs had increased; and it was quite possible that, without such improvements, "the probable earning capacity would have been substantially reduced." (R. 244) Current assets need not be reflected in new capitalization (R. 243, 246). Thus the court concluded:

> "Courts may interfere with the capital structure or valuation made by the Commission in a proceeding under this Act only when it can be said as a matter of law that the Commission used fundamentally erroneous methods of valuation or acted arbitrarily or capriciously. An examination of the entire record leads to the conclusion that the action and the conduct of the

Commission in fixing the valuation and setting up the capital structure is free from these infirmities, and that its action in relation thereto must be upheld." (R. 245)

Finally, the court noted that:

> "On appeal, our scope of review is more limited than even that of the District Court. We inquire only to ascertain whether the District Court performed its judicial functions under Subsection (e) and whether its conclusions find support in the record. We may not reverse the District Court merely because we would have reached a different conclusion. As stated by the Supreme Court, 'If there is warrant for the action of the District Court, our task on review is at an end.'" (R. 245-46)

After these orthodox pronouncements, the court moved into the second part of its opinion, the area of action. Here a different philosophy prevails. The court evidently considers that it is entitled to exercise its own independent judgment on matters of relative value, on the cash needs of the property and on future earnings.

The governing premise of the actual decision is rooted in the first of these, the matter of relative values. Here the court declares that, by the receipt of an equal face amount of new securities, though in most instances of junior grades and largely Common Stock,

> "The Senior Bondholders were *paid in full.*" (R. 247, italics added.)

Passing then to the second point, the cash needs of the property, the court holds:

> "The Senior Bondholders were entitled to receive in addition to the full amount of their claims [*sic*], working capital sufficient for proper and efficient operation of the railroad. But anything in excess of what was reasonably necessary for this purpose constituted assets

> of the insolvent corporation which *belonged to the remaining creditors.*" (R. 247, italics added)

"*We* think it is apparent," the court says,[54] in an evident exercise of its own original judgment, that there were

> "current assets on hand consisting of cash and securities in excess of what was needed for the efficient operation of the road." (R. 247)

Moving on to the third point, the course of future earnings, the court again calls on its independent judgment and prophesies that large war earnings will continue "for a reasonable time" (R. 247).

Thus as a result of all three points the court concludes that two changes must be made in the Plan, first, as to cash on hand, and, second, as to future earnings of the war period:

> "We think any plan which fails to take this into account and which gives the Senior Bondholders their claims in full by substantially delivering the road to them, and gives them the surplus cash actually on hand and further enables them to receive in addition the excess war profits which are reasonably sure to come, is inherently inequitable and unfair, so long as there are classes of creditors whose claims are not fully satisfied."[55]

Gaining confidence from this initial exercise of its independent judgment on future earnings in the particular period of war-time, the court now advances to the unlimited period of the long future. Heedless of the "outer realm of speculation," where it had said the post-war traffic of new industries lay (R. 242), and the "increased cost of operation", which it had so rightly stressed at an earlier point (R. 244), the court now requires a third change in the Commission Plan:

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[54] R. 247, italics added.

[55] R. 247. Repeated, with minor variations of form, at R. 248 and 249.

"We, however, feel that there is *more than* a speculative probability that these war industries which have been constructed along the system, as well as the improvements which have been made by the use of these net earnings, *might* produce greater net returns than anticipated in the plan. If such should be the case, they *certainly belong to the General Bondholders* and not to the Seniors; and the *plan should bring this about.* It could be done by issuing to the General Bondholders an additional amount of a *subordinate stock which would receive returns only from excess dividends.* This is a mere suggestion on our part, and in no wise binding on the Commission. Our duty is limited to pointing out *defects* in the plan. It is the responsibility of the Commission to correct them." (R. 250, italics added)

After requiring these three changes in the Plan, the court took up certain special issues and required three further changes in the Plan:

(*i*) Since the Senior Creditors are "paid in full" by new securities, the "undistributed value" behind the securities originally provided for the Junction Bonds (now held by the estate) must be given to the General Mortgage Bonds (R. 251).

(*ii*) Since the Senior Creditors are "fully compensated" by new securities, the "unused value" behind the "new securities" originally provided for $1,218,000 of equipment obligations now retired must be given to the Generals (R. 251).

(*iii*) The Western Consolidated bondholders, who have a first lien on the stock owned by the Missouri Pacific and the Western Pacific in Utah Fuel Company, must "credit the value of this collateral upon their claim before sharing in the securities of the reorganized company." (R. 252).

Finally, the court held that the General Mortgage bondholders were "reasonably justified" (Section 77(e)) in rejecting the Plan and the District Court was without authority to confirm it over their adverse vote (R. 253).

The court, however, approved the finding of the District Court that the old stock was without value and the order barring them from participation (R. 254). Nothing was said about general creditors, though the same result was presumably intended.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court erred:

1. In holding that the Plan must be modified so as to distribute any part of the cash on hand in any way other than according to the terms of the Plan as a return on the new securities provided for in it.

2. In holding that the Plan must be modified so as to give the General Mortgage Bonds all earnings for the future above any particular level, whether during the remainder of the war period or thereafter.

3. In holding that the Plan must be modified so as to give the General Mortgage bondholders anything because of the serial payment of equipment trust obligations or the purchase of the Junction Bonds.

4. In holding that the Plan must be modified so as to reduce the claim of the Western Consolidated Bonds by any amount for their pledged Utah Fuel Company stock before awarding them new securities.

5. In holding that the dissent of the General Mortgage bondholders precluded confirmation of the Plan.

SUMMARY OF ARGUMENT

I

THE CIRCUIT COURT ERRED IN MODIFYING THE PLAN SO AS TO DISTRIBUTE CASH ON HAND

The decisive date for this purpose is the time of the finding by the Commission. (Page 37 below.)

The Act requires that the validity of Commission action in limiting the recognition of a junior class shall be determined as of "the time of the finding" by the Commission (sub-section (e) of Section 77).

In applying that standard, the District Court may take into consideration all changes of condition to the time of its approval of the plan, or, where a class dissents, as here, to the time of its confirmation of the plan. But no later events are relevant under the Act.

The Plan was confirmed on November 29, 1944. Since the interval to December 31, 1944, was too short for any significant change, and year-end figures are more informative, that date closes the factual material by which the Commission's action is to be judged.

The concurring action of the Commission and the District Court in this case is a final determination of what the public interest permits. (Page 42 below.)

The Commission implicitly found that present and prospective cash position did not justify any change in the Plan. The District Court so held. These discretionary determinations were entitled to respect in the Circuit Court; for there was evidence to support them. Indeed, on the evidence it is clear that, so far from any surplus of cash, there is a serious deficiency. Net current assets are manifestly inadequate to provide in full for all operating needs, the accumulated improvement requirement and a fair return on

the new securities provided for in the Plan for the period elapsed since its stated effective date.

The Circuit Court had jurisdiction only to determine whether there was warrant for the action of the District Court. It erred in exercising its independent judgment on the financial needs of the property. It further erred in finding a distributable surplus.

The concurring action of the Commission and the District Court in this case is a final determination of what is required for satisfaction of private rights under the priority rule. (Page 50 below.)

It was a function of the Commission and the District Court to determine whether Senior Creditors were "made whole" (*Milwaukee Case*, 318 U. S. at 566). They rested their determination largely on the limited recognition given the General Mortgage Bonds and made no finding that the new securities would have a value equal to their face amount. The contrary was evidently their expectation, especially in the case of the new Common Stock. The District Court expressly found that it would have "little or no value" (R. 220) and, if any, then wholly because of the improvement work and the cash on hand (R. 222).

So the action of the fact-finding tribunals does not support, but indeed negatives, the premise of the Circuit Court that the Senior Creditors are made whole by the mere receipt of these new securities in a face amount equal to their claim. The Circuit Court was not entitled to exercise its original judgment on this question of value and the evidence requires the contrary conclusion.

The Circuit Court further erred in taking the view that such a value for the new Common as the residual owner of the whole bundle of assets would remain undiminished even though large sums of cash are stripped from the treasury.

The Circuit Court further erred in directing that such

cash be distributed to the General Mortgage Bonds while the Senior Creditors must take new securities, in large part of junior grades (or in directing that an equal amount of the new Common Stock be transferred from the Senior Creditors to the Generals if the cash is to go to the Senior Creditors).

II

The Circuit Court Erred in Modifying the Plan so as to Give Additional New Common Stock to the Generals.

The Circuit Court invades the Commission's function which is to fix a new capitalization consistent with the public interest. (Page 55 below.)

The Commission's determination of new capitalization, made in accord with prospective earning capacity as the primary criterion of reorganization value, is conclusive when supported by evidence (*Western Pacific Case*, 318 U. S. 448, *Milwaukee Case*, 318 U. S. 523).

Historical earnings, except in the extraordinary years of war time, which are not a reliable guide, have not been adequate to provide a fair return on the new securities provided for in the Plan.

Rising levels of unit costs have largely offset the economies from the improvement program and continue in such way as to raise a serious problem for the future.

Drastic declines that have occurred in rate levels add to the reservations with which past earnings must be viewed.

Such evidence fully supports the Commission's conclusions on the new capitalization. Indeed that capitalization is liberal, whether measured by this property alone or against the average of Commission plans.

The public interest is directly jeopardized by the increases in capitalization required by the Circuit Court.

The Circuit Court defeats the private right of creditors to full satisfaction of their claims. (Page 69 below.)

It is not enough that the Senior Creditors retain some seniority of position to junior interests, as the Circuit Court apparently thought, but they are entitled to receive realizable value in the full amount of their claims before the General Mortgage Bonds are entitled to receive anything: *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106 (1939); *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510 (1941); *Western Pacific Case*, 318 U. S. 448; *Milwaukee Case*, 318 U. S. 523.

If full compensation is to be attained in fact, such value must reflect what people will probably pay, either now or within some assured future.

The Commission and the District Court made no finding of such value, or of any particular value, but based their approval largely on the ground that the new Common Stock represents the entire residual equity and is given wholly to the Senior Creditors except for a minor participation of 10% to the Generals. The Circuit Court, by requiring a further issue of stock for the Generals, breaks down each of these justifications for the Plan, without any assurance that what it leaves the Senior Creditors will make them whole.

III

THE CIRCUIT COURT ERRED IN REQUIRING THE ISSUANCE OF NEW SECURITIES IN LIEU OF OLD OBLIGATIONS PAID OR PURCHASED SINCE THE STATED EFFECTIVE DATE OF THE PLAN AND IN REQUIRING THE USE OF SUCH SECURITIES FOR THE BENEFIT, DIRECTLY OR INDIRECTLY, OF THE GENERAL MORTGAGE BONDS. (Page 52 below.)

The estate has less cash because of these transactions and its net value is not increased.

The Plan provides that any reduction of "equipment obligations or other liabilities" should reduce new capitalization by an equal amount, and this, being within the Commission's power, is conclusive.

Those allotted the new securities under the Plan are entitled to the entire bundle of assets and their substantive right of ownership can not be abridged by a mere shift of value into successive forms, whether by exchange of one asset for another or by application of an asset to reduce a liability (*In re Chicago, Rock Island and Pacific R.* —— F. S. —— (N. D. Ill. 1945) 9).

IV

THE CIRCUIT COURT ERRED IN REQUIRING THE WESTERN CONSOLIDATED BONDHOLDERS TO REDUCE THEIR CLAIM BY THE VALUE OF THEIR LIEN ON THE UTAH FUEL STOCK BEFORE RECEIVING ANY NEW SECURITIES. (Page 89 below.)

The stock in Utah Fuel Company is pledged under the Western Consolidated Mortgage as a first lien and the R&I Mortgage and General Mortgage as junior liens. The equity of redemption, however, is not vested in the Debtor but in the Missouri Pacific and Western Pacific, who own "the ultimate beneficial interest."

Since the stock is not property of the Debtor, it is not subject to the jurisdiction of the Commission and courts under Section 77, for that deals only with "the debtor and its property" (subdivision (a) and *Western Pacific Case*, 318 U. S. at 506). By the same token it is not subject to the bankruptcy rule of proving for the net amount only, for that rule applies only to "security . . . upon the property of the bankrupt" (Section 1 (28) and Section 57 (h) of the Bankruptcy Act).

The equity rule, therefore, governs and the Western Consolidated bondholders are entitled, as in fact the Plan

provides, to receive new securities in respect of their total claim and thereafter to proceed against the pledged collateral, subject only to the limitation that their subsequent realization from the pledged collateral may not bring their total recovery above the amount of their claim: *Ivanhoe Building and Loan Association* v. *Orr*, 295 U. S. 243 (1935); *Western Pacific Case*, 318 U. S. 448; *In the Matter of The Western Pacific R.*, unreported (N. D. Cal. 1944), *aff. sub. nom. The Railroad Credit Corporation* v. *Ecker*, —— F. 2d. —— (C. C. A. 9, 1945).

V

The Circuit Court Erred in Holding That the Dissent of the General Mortgage Bondholders Precluded Confirmation of the Plan. (Page 100 below.)

A main purpose of the 1935 amendments to Section 77 was to eliminate the obstructions of private veto power by authorizing the District Court to put a plan in effect over a dissent upon finding it fair and equitable (subdivision (e)).

This is within the constitutional power of the Congress to adjust procedural forms to the evolving public need: *In re Chicago and North Western R.*, 126 F. 2d 351 (C. C. A. 7, 1942), *cert. den.* 318 U. S. 793 (1943); *In re Missouri Pacific R.*, 50 F. S. 936 (E.D. Mo. 1943); *Wright* v. *Union Central Life Insurance Co.*, 311 U. S. 273 (1940), *reh'g. den.* 312 U. S. 711 (1941); *Western Pacific Case*, 318 U. S. 448.

ARGUMENT

I.

DISTRIBUTION OF CASH ON HAND

1. The Decisive Date Is the Time of the Finding by the Commission.

One of the fundamental purposes of the Congress in originally enacting Section 77 was to provide an expeditious procedure for railroad reorganizations that would avoid the delays of prior equity practice.[36] This continues to be a matter of lively concern to the Congress.[37]

It was soon realized, however, that the Act was not likely to accomplish this purpose without extensive revision.[38] The principal difficulty was that the court could not confirm a plan until it was approved by the Commission and the Commission could not approve a plan until it was accepted by the security-holders, unless certain special steps should be taken.[39] All of these were commonly thought to involve a judicial finding of value. In result, junior securities could not be excluded without a judicial finding of value. But the complications, expense and delay of judicial proceedings on that issue were well known. They had become famous in public utility rate regulation. Their effect was to give junior security holders a practical power of veto.

The public purposes of the Congress should not, it was felt, be thwarted by such obstructions. The main purpose of the 1935 amendments, offered after long study by the Federal Coordinator of Transportation and his counsel, was to

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[36] H. R. Rep. No. 1897, 72d Cong., 2d Sess. (1933) 5, 8.

[37] Thus see S. Res. 192, introduced by Senator Wheeler on November 16, 1945, to inquire into the causes of delay.

[38] Annual Report of Interstate Commerce Commission for 1934, quoted in Hearings before H. R. Comm. on Judiciary on H. R. 6249, 74th Cong., 1st Sess. (1935) 66.

[39] Subdivision (e) and subdivision (g), clauses (5) and (6).

eliminate that veto power.[60] In this way it was hoped to give the Commission the power of going ahead.

The means chosen were two, to supply a simplified test of value for reorganization purposes and to authorize the District Court to confirm despite a dissent. The latter will be dealt with in V below. The former is pertinent here.

The test of value was realistically defined as prospective earning capacity, with an express negation of reproduction cost and other elements of physical value.[61] By this means it was hoped to avoid one source of delay in valuations, namely, that implicit in the complexities of the questions. They were emphasized at great length in the hearings,[62] *e. g.*, they were said to require the use of "3 days talking about the price of a little single item, to wit, cast-iron pipe."[63]

Another great source of delay in rate regulation was the absence of any fixed date of decision, so that the decisive date was in constant movement as time went by. As the process of regulation and review continued on its leisurely course, "the actual results of the Company's business during the intervening years"[64] were pertinent, so a new point of computation was repeatedly required.[65] However appropriate that might be under rate orders of continuing operation, there was no justification for it in reorganization, where participations had been historically fixed at the single

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[60]Hearings before H. R. Comm. on Judiciary on H. R. 6249, 74th Cong., 1st Sess. (1935) 15, 22, 25-26, 45, 66, 130. *e. g.*, "there is such a dead center that movement forward is impossible or at least extremely difficult" (25); the "possibility of getting through a plan . . . is obstructed by the necessity of a valuation of the property" (26).

[61]Section 77(e), last paragraph. Construed and sustained in *Milwaukee Case*, 318 U. S. at 539-41.

[62]Hearings before H. R. Comm. on Judiciary on H. R. 6249, 74th Cong., 1st Sess. (1935) 15, 22, 25-32, 105-8, 290, 316.

[63]*Id.*, 319. See also Craven and Fuller, *The 1935 Amendments of the Railroad Bankruptcy Law* (1936), 49 Harv. L. Rev. 1254, 1268-76.

[64]*McCart* v. *Indianapolis Water Co.*, 302 U. S. 419, 422 (1938).

[65]*Id.*, p. 435 and cases cited.

decisive moment of foreclosure sale. The House Committee itself stopped this gap by prescribing as the corresponding decisive moment under Section 77 the time of the Commission's finding. This it did by inserting in the bill the words italicized below:

> "The plan shall then be submitted by the Commission to the creditors of each class . . . and to the stockholders of each class . . . for acceptance or rejection . . . Provided, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that *at the time of the finding* the corporation is insolvent, or that *at the time of the finding* the equity of such class of stockholders has no value . . . Provided further, That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, . . . that *at the time of the finding* the interests of such class of creditors have no value. . . ."[*]

The effect of this provision was that, such a finding having been made by the Commission and affirmed by the District Court, not only was there to be, procedurally, no submission of the plan to such class of creditors, but also, as a substantive matter under the fair and equitable standard, the plan lawfully might, and, indeed, to be lawful must, deny any recognition to that class of creditors. In other words, the Congress foresaw that the only way to provide a workable reorganization system was to prescribe a decisive date as of which value for reorganization purposes was to be determined. For that date it chose the time of the Commission finding and directed that particular classes of creditors and

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[*] Italics added. In the original the words "Provided" and "Provided further" are italicized. Source: compare the bill in Committee (Hearings, *supra*, p. 7) with the bill reported by the Committee (H. R. Rep. No. 1283, 74th Cong., 1st Sess. (1935) 18).

stockholders should be excluded from participation if, as of that time, the value of the road for reorganization purposes and, by that token, the permissible amount of the new capitalization, should be inadequate to provide anything for their claims.

Where a junior creditor complains, not of total exclusion, as in the situation just discussed, but of limited recognition, though he receives everything that is left after providing for senior claims, as here, the question is just the same, for in each case the attack is on the amount of the value for reorganization purposes and the permissible new capitalization. It would frustrate the Congressional scheme to hold that, while the rights of a creditor who receives nothing are determined as of the time of the Commission's finding, the rights of a creditor who receives 10% of his claim are determined as of some other date. The Congressional purpose requires that the same test be applied in each case.

The "time of the finding" by the Commission is therefore decisive in these appeals.[67]

Only one expansion of that "time" seems permissible under the Act. While it is the evident policy of the Act to entrust the Commission with the full scope of administrative finality, the Commission's action is nevertheless closely "brigaded"[68] with that of the District Court and the Commission's finding is not viewed as having operative effect until approved by the District Court. It may follow from this that the District Court, in approving a plan, is entitled to consider any changes of condition to that time. But consistently with the statutory purpose, such events should be appraised as of the time of the Commission's finding and the only question is whether they are of such revolutionary effect that no reasonable mind could, with an expectation

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[67] So stated in *Akron, Canton & Youngstown R.* v. *Hagenbuch*, 128 F. 2d 932, 939 (C.C.A. 6, 1942), *cert. den.* 318 U. S. 794 (1943).

[68] *Palmer* v. *Massachusetts*, 308 U. S. 79, 87 (1939).

of such occurrences, have reached the conclusion that the Commission reached when the Commission reached it.

In one situation the District Court must again review the merits of a plan. Where a plan, having been approved by the Commission and the District Court, is submitted to creditors and one or more voting classes dissent, as here, the District Court, before confirming the plan, must again find the plan fair and equitable. The Act directs that in this connection the District Court shall consider "all the relevant facts."[69] This does not disturb the statutory standard of the "time of the finding" by the Commission, but it does contemplate that, in the application of that standard, the District Court shall consider occurrences to the date of confirmation, just as before it considered occurrences to the date of approval.

So in each case the validity of the Commission's action is to be judged as of the date of the Commission's action. From that point of view, evidence may be considered of later changes to the time of approval, or, where a class dissents, to the time of confirmation. But no later events are relevant under the Act.

Upon confirmation by the District Court, the function of original decision by the Commission and the District Court has been completed and the only permissible function of review on appeal is to determine whether "there is warrant for the action of the District Court" (*Milwaukee Case*, 318 U. S. at 564). This limitation on appellate action is responsive not only to the specific policies of Section 77, but also to broader considerations, springing from the fuller information of the District Court and the requirements of orderly judicial procedure.[70]

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[69] Next to last paragraph of Section 77(e), discussed further in V below.

[70] *Kansas City Terminal R. v. Central Union Trust Co.*, 28 F. 2d 177 (C.C.A. 8, 1928), *cert. den.* 278 U. S. 655 (1929); *Badenhausen v. Guaranty Trust Company of N. Y.*, 145 F. 2d 40 (C. C. A. 4, 1944), *cert. den.* 323 U. S. 797 (1945).

In this case, the Commission approved the Plan on June 13, 1943, and certified it to the District Court on June 28, 1943.[71] The opinion approving the Plan was filed on October 25, 1943. The opinion confirming the Plan was filed on November 1, 1944. The order confirming the Plan was entered on November 29, 1944. Year-end figures being, as a practical matter, ordinarily more informative, and the interval here being too short for any significant change, December 31, 1944, is the date that closes the factual material which may be considered in determining the validity of the Commission's action in these cases.

2. The Concurring Action of the Commission and the District Court is a Final Determination of What the Public Interest Permits.

Cash and net current assets (including such cash) at dates near "the time of the finding" by the Commission on June 13, 1943, were as follows:[72]

Date	*Millions of Dollars*	
	Cash	*Net Current Assets*
Jan. 1, 1943	10	11
May 31, 1943	10	14
Dec. 31, 1943	13	14

All this was in line with the Commission's expectations. The 10 million of cash at the beginning of the year was of record before it, and was given weight in its Report (R. 155). The Commission estimated that cash at the end of the year would approximate 15.6 million (R. 158). The actual figure was 12.7 million[73] and apart from the unanticipated purchase of the Junction Bonds it would have been

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[71] D. Ct. Pro. 10,777.

[72] R. 606-9; R. 1189-90; and Annual Report 1943, pp. 12-13. Government obligations were less than accrued tax liability at each of the dates mentioned in the table and so are not included with cash. Here, as always, we exclude from current liabilities the notes that are provided for in the Plan (for they are not current demands).

[73] Annual Report 1943, p. 12.

15.6 (R. 277), surely a striking testimonial of the Commission's insight into the situation of the property.

These sums were, of course, far in excess of the cash fund required to protect current operations, for which between one and a quarter and two million dollars had been estimated, though at lower traffic levels (R. 155). But current operations were not the only call for cash. There were the general requirements of conservative management. These include adequate stores of Material and Supplies (listed as a current asset but in effect appropriated for the needs of the physical plant). They also include reserves for future contingencies, not only for specific potential liabilities, such as final assessment of taxes and readjustment of land grant rates (R. 282-83), but also for the inevitable uncertainties of the postwar transition, when new facilities may be imperative to preserve competitive position. In addition, the expenses of the reorganization must be met, including, in the event of consolidation, the cash payments to non-assenting holders of Salt Lake Bonds. This property, moreover, could not be viewed apart from its heavy backlog of improvement requirements (R. 157-8). And, finally, for any period after the stated effective date of the Plan on January 1, 1943, all proper charges under the Plan would, of course, have to be taken into account in order to cover accruals of interest on the new bonds and provide for dividends at the designated rate on the new Preferred Stock and a fair return on the new Common (R. 158), because those who receive the new securities are entitled to the income after the stated effective date of the Plan.

In the light of such considerations, typically within the field of the Commission's expert administrative judgment, the Commission found that:

> "The present cash position and earning power of the Denver are adequate assurance that any probable amount of cash required for paying the remaining re-

> organization expenses and the refunding or payment of non-assenting Salt Lake bonds can be met from funds on hand." (R. 155).

The Commission accordingly eliminated from the Plan its former provision for borrowing new money. But it did not think fit to do more. This action, we submit, is implicitly a finding that the present and prospective cash position were not such as to justify any change in the capitalization or allocations in the Plan. This finding is entitled to the same measure of respect by the courts as if refusing for any other reason to change the permissible amount of the new capitalization or its allocation among the old securities. It is thus conclusive if within the area of reasonable judgment, which it certainly is in this case. As the Circuit Court of Appeals for the Second Circuit said in refusing to disturb a Commission plan upon a similar attack:

> "It is for the informed judgment of the Commission rather than for the courts to determine the sufficiency of any cash reserve to meet the uncertainties ahead." (*In re The New York, New Haven & Hartford R.*, 147 F. 2d 40, 46 (C.C.A. 2, 1945)).

Granted, however, that the District Court retains considerable freedom of discretionary judgment as to the use of cash under its administration, the District Court affirmed the Commission's conclusions. It did so both in approving the Plan and in confirming it.

At the first of these times the General Mortgage Trustee objected that:

> "The Plan fails to give sufficient weight to the great improvement in the financial position of the Debtor" (D. Ct. Pro. 10,381).

The District Court overruled this objection and approved the plan (R. 207, October 25, 1943).

About a year later the Plan came on for confirmation and the General Mortgage Trustee specifically urged that "the accumulation of surplus cash" should be applied on the Senior Claims and that new securities which would not, after such payment, be needed to satisfy the Senior Claims should be redistributed to the General Mortgage Bonds (R. 645 and 648). This request also was denied by the District Court in its order confirming the Plan (R. 230).

At that time (substantially December 31, 1944) cash plus the excess of Government obligations over accrued tax liability equalled 12 million dollars and net current assets (including the cash and Governments) were 16 million dollars. This was not far from the condition at the time of the Commission's action, about one or two million more in each instance. What were the requirements to be met from those funds?

First of all, of course, there must be adequate provision for the operating needs of the property, including the cash working fund, the necessary Material and Supplies, expenses of reorganization and reserves for contingencies.

Then there must be due provision for necessary improvements to the property. The amount required for the improvement program and carry-over at December 31, 1944, was 7 million dollars (R. 1199). Those funds can not be provided from sale of new securities, for that would exceed the Commission's limits for the new capitalization at the very moment of its issuance.

Without attempting to assign any particular figure for the operating needs referred to above, it is plain that the size of the improvement requirement is such as to raise a serious question whether both needs can be provided for in their entirety. At the least it is impossible to say that there is no basis on which a reasonable mind could conclude that there is no cash surplus to distribute.

But that is not all. The Plan recognizes interest on the Senior Claims only to January 1, 1943 (its stated effective

date), and after that time intends to substitute interest accruals on the new bonds and a fair return on the new stock. Until such amounts are paid or provided, a matter to which the Circuit Court seemingly gave no attention, there can be no question of surplus funds, since not until that time will the Plan work as intended or make any approach to full compensation for Senior Claims. The rate of a fair return is fixed by the Plan for the new bonds and the Preferred Stock. For the new Common it, of course, is not. But the prospect of "unlimited . . . dividends" on the Common was expressly relied on by the Commission as a part of its basis for finding adequate compensation to Senior Creditors under the terms of the Plan (R. 167). The average rate of return on the Common should be greater than the 5% rate fixed for the Preferred in order to compensate for the greater risks of the junior position. This requires generous payments in years of unusual prosperity, substantially greater than the desired average, for otherwise the average can never be maintained at the perimeter of earnings where this new Common lies. At a 10% dividend rate on the new Common the unpaid accruals under the Plan for interest and dividends to December 31, 1944, were 15 million dollars.* At a mere average rate of 6% for Common dividends, unpaid accruals were 11 millions. Without any provision for Common dividends at all, unpaid accruals through the Preferred were 6 millions. None of these amounts can be provided for in full if the whole of the improvement requirements are to be satisfied. In these circumstances there is a very ominous likelihood that no Common dividends whatever will be paid for even these two brilliant years of 1943-1944 when, under the stimulus of abnormal war conditions, earnings soared above all pre-war peaks.

This is shown in very concrete form if we put the matter the other way and provide a return on the new securities

*This is the net figure, after deducting the interest payment of 2.4 million made in 1944 (R. 634).

before taking care of any other requirements. Allowing, for the purposes of this illustration, Common dividends at the inadequate rate of merely 5%, the current position would have been as follows (in thousands of dollars at Dec. 31):

	1942	1943	1944
Current assets	$21,025	$27,266	$21,765
Current liabilities	9,560	20,033	17,055
Net current assets	$11,465	$ 7,233	$ 4,710
Current ratio	2.20	1.36	1.28
Current ratio for all Class I railroads[35]	1.71	1.55	1.59

Thus, without any provision for operating requirements, there would have been on hand at the end of 1944 only 4.7 million dollars of net current assets to satisfy the improvement program requirement at that time of 7 million dollars. Of course no such calamitous deficiency in net position could be allowed to occur.

In these circumstances, where the current position does not even permit a fair return on the stock provided for in the Plan, we submit it is impossible to find any surplus from which debt dealt with in the Plan must be retired for the benefit of junior interests.[36]

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[35] I.C.C. Statement M-125, Selected Income and Balance Sheet Items of Class I Steam Railways in the United States, December 1943 and 1944.

[36] This situation is essentially different from that presented in the cases urged below by the General Mortgage Trustee:

In Re Florida East Coast R., 52 F. S. 420 (S. D. Fla. 1943);
Chicago, Milwaukee, St. Paul & Pacific R. Reorganization, 257 I. C. C. 223 (1944);
In Re New York, New Haven and Hartford R., 54 F. S. 595 (D. Conn. 1943), *aff.* 147 F. 2d 40 (C.C.A. 2, 1945), *cert. den.* —— U. S. ——, 89 L. Ed. 1553 (1945).

In each of those cases interest on all, or most all, of the underlying bonds had been paid in full and, at the time of District Court hearings on approval of the plan (or confirmation when a class of security holders had dissented), there was still a very large *actual surplus* of cash that, as said in the first of those cases, was "prudently available" for distribution.

So the District Court rightly had no hesitation in rejecting the request of the General Mortgage Trustee for a distribution of funds for this purpose (R. 230).

This question of the financial needs of the road was a purely factual one. The existence or extent of surplus net current assets is nothing but a question of fact. It can not be masked, in the words of the Circuit Court, as "a pure question of law" (R. 253). On such matters the Circuit Court has neither the experience nor the facilities for an original judgment. To dispose of the problem in such terms is to disregard the finding of the Commission, though uniformly entitled to finality on the facts as a matter of administrative function,[77] and the judgment of the District Court, though uniformly entitled to finality on facts of this kind as a matter of judicial discretion.[78] These general principles are adopted in Section 77, which confides the decision of such matters to the concurring action of the Commission and the District Court and limits the scope of review to the question whether "there is warrant for the action of the District Court" (*Milwaukee Case*, 318 U. S. at 564). Heedless, however, of these fundamental limitations on its appellate jurisdiction, the Circuit Court undertook to substitute its own judgment on this factual question, saying, without any review of operating needs, or improvement requirements or accruals under the Plan:

> "*We* think it is apparent from the record that there are current assets on hand consisting of cash and securi-

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[77] *E. g., I.C.C.* v. *Illinois Central R.*, 215 U. S. 452, 469-70 (1910); *U. S.* v. *Detroit and Cleveland Navigation Co.*, —— U. S. ——, 90 L. Ed. 12 (1945).

[78] *E. g., In Re Philadelphia & Reading Coal & Iron Co.*, 141 F. 2d 954 (C.C.A. 3, 1944); *In Re Philadelphia & Reading Coal & Iron Co.*, 117 F. 2d 976, 978-9 (C.C.A. 3, 1941); *Van Schaick* v. *McCarthy*, 116 F. 2d 987, 993 (C.C.A. 10, 1941); *In Re St. Louis Southwestern R.*, 17 F. S. 68 (E. D. Mo. 1936), *aff. sub. nom. Bankers Trust Co* v. *Henwood*, 88 F. 2d 163 (C.C.A. 8, 1937).

ties in excess of what was needed for the efficient operation of the road." (R. 247, italics added).

To the extent, though apparently an incidental one, that the Circuit Court relied on the District Court's observation in the opinion approving the Plan that, for the purpose of the purchase of the Junction Bonds, there was on hand "an amount of cash far in excess of the needs of reorganization expenses, including working capital" (R. 248), it misconceived the meaning of the District Court. That statement, even if not superseded by the later order confirming the Plan, did not deal with improvement requirements or with accruals under the Plan. And it certainly was not intended as a finding that there was any genuine surplus in an overall view. The same is true of the oral, and thus less exactly phrased, remark at the September 1943 hearing that the road "has an amount of cash here that it is not necessary to carry forward into the reorganization" (R. 262). The District Court's position on cash has been clear and consistent at all times. It refused to make any payment on old securities, even from the unprecedented earnings of 1942 (R. 1018), until there was an approved Plan, and then paid only such amounts as were equal to the interest that would be mandatorily payable on the new bonds at the time of their issuance (R. 634). Apart from that, the only distribution was the purchase of the Junction Bonds, which would reduce the initial debt capitalization. In other words, no distribution of cash has been made on old securities except where operating to pay or reduce the obligations of the reorganized company.

If, on the other hand, the Circuit Court was looking, as its bare words may imply, only to the cash required for current operation of the physical property, this was likewise a usurpation of the function of the Commission and the District Court. They were entitled to see that the reorganized

company is equipped not only for current operation of the physical property, but also to maintain its system as a going concern, protected against all reasonable contingencies, able to meet its improvement needs and qualified to pay a fair return on the new securities provided for in the Plan.

So the Circuit Court, we submit, overstepped the limits of its appellate power, and its decision cannot be supported on the facts. The result of its apparent direction for a substantial distribution of cash may well be to impede or prevent the orderly operation of any plan.

3. The Concurring Action of the Commission and the District Court is a Final Determination of What the Priority Rule Requires.

Up to this point we have dealt in terms of the public interest in the preservation of adequate funds for the needs of the property, referring to private rights only in so far as a fair return on the new securities marks one of the needs to be met. But in still another respect, the vital matter of determining due satisfaction of the priority rule, the action of the Circuit Court conflicts with established principles. The original determination of this question also is a function of the Commission and the District Court. This Court has said:

> "Whether in a given case senior creditors have been made whole or received 'full compensatory treatment' rests in the informed judgment of the Commission and the District Court on consideration of all relevant facts." (*Milwaukee Case*, 318 U. S. at 566)

The Commission and the District Court discharged this function, but obviously based their conclusion in large part on the limited participation permitted the General's in the Plan, the very limitation that the Circuit Court destroys. There was, as we point out more fully at page 77 below, no finding by the Commission or the District Court that any of

the new securities, and most particularly, of course, the shares of new Common Stock, would have a value equal to their face amount, that being the amount at which they were distributed in the Plan in satisfaction of the Senior Claims. Nor was there any finding of any particular amount of prospective future earnings available for dividends on the Common Stock. The Commission contented itself with the finding that "under the provisions of the plan" (R. 169), among the most important of which was the limited recognition given to the General Mortgage Bonds, so that the Senior Creditors took nearly all of what there was, the compensation to Senior Creditors "would be adequate" (R. 169). As for realizable value, it was evidently the Commission's expectation that the new stocks would sell substantially below their par amount, for it held that RFC, upon receiving its total claim in new First Mortgage Bonds and Income Bonds, was "not fully secured" (R. 178) and was thus entitled to additional amounts representing payments on its rental claim. The District Court, for its part, found in terms that the new Common Stock "has little or no value" (R. 220), and, if any, then wholly because of the improvement work and the current assets on hand (R. 222).

So the Circuit Court had no basis in any action of the fact-finding tribunals when it took the view that the new securities, even the new Common Stock, would have a value equal to their face amount (R. 247). This was a new pronouncement of its own, made *ex cathedra*, without analysis of the facts of record and without reference to any price at which the new Common Stock may be sold, either now or at any foreseeable future time. If this pronouncement purports to be an original finding by the Circuit Court, we submit that action is beyond the proper limits of its appellate function. If it is not such a finding, it is a mere assumption that new securities are automatically worth their face amount without reference to their quality or earning power. On the facts,

as we show more fully below, the historical earnings of the road give no assurance, but on the contrary make it most unlikely, that the new Common Stock will have a value equal to its par amount within any foreseeable future time (p. 50), and these indications are corroborated by when-issued market quotations, which value the new Common Stock at roughly one-third its par amount.[79] So we submit that this fundamental premise of the Circuit Court is not only unsupported by the action of the fact-finding tribunals, but indeed is contrary to their action, and, wholly apart from their action, is contrary to the evidence. The fundamental requirement for full satisfaction of senior debt cannot survive in actual practice if applied only in these paper terms. Yet it was only by such an assumption that the Circuit Court upset the Plan.

Equipped with this premise, the Circuit Court takes a further step. The value attributed to the new Common as the residual owner of the entire bundle of assets will, the Circuit Court further assumes, remain undiminished even though large sums are stripped from the treasury, so that the road is left only with such net current assets as may be essential for bare operating needs.[80] At this point it is of no concern whether there was or was not a surplus of current assets, for, however the assets may be classified, there is no doubt that they were all taken into account by the Commission and the District Court in their respective findings that the Plan is fair and equitable. It is obvious, particularly in the circumstances of this case, that the present and prospec-

[79]See Appendix G and the discussion of it on p. 80 below.

[80]Indeed, the Circuit Court thinks the assumed value will persist even if *all* net current assets are distributed, leaving only the bare bones of the physical plant; for the Circuit Court, though generously according the Senior Creditors "working capital sufficient for proper and efficient operation of the railroad", evidently thinks that would involve an *excess* recovery "in addition to the full amount of their claims" (R. 247).

tive cash position of the road was a factor, and a material one, on which the Commission based its finding that compensation to Senior Creditors is "adequate under the provisions of the plan" (R. 169). It was expressly relied on by the District Court as one of the only reasons for a value in the new Common Stock (R. 222).

So if current assets might fairly be said to include any surplus beyond the needs of the road, that surplus belongs to the Senior Creditors, as recipients of 90% of the new Common stock, and is a necessary component of their award in order to make out adequate compensation on this record and permit any participation at all by the General Mortgage Bonds. Since the Commission and the District Court viewed the property in the context of its cash resources, clearly neither one of them considered the value of the new securities apart from the cash resources and the Circuit Court was on wholly new ground when it found or assumed a value in such circumstances.

That conclusion, contrary to the evidence even with the cash in the till, is all the more so with the cash gone. It becomes a mere fantasy when the cash is to go, as the Circuit Court requires, in such amounts as to preclude completion of the necessary improvement work and make wholly impossible any approach to a fair return on the new securities from the effective date of the Plan, The priority rule under such manipulation becomes a mere matter of history.

But this does not deter the Circuit Court. It has such confidence in the concept that securities are counters of fixed value that it apparently takes still another step into error by directing that the required distribution of cash be made to junior creditors. Its words are:

> "The Senior Bondholders were entitled to receive in addition [*sic*] to the full amount of their claims, working capital sufficient for proper and efficient operation of the railroad. But anything in excess of what was reasonably necessary for this purpose constituted assets

> of the insolvent corporation which belonged to the remaining creditors." (R. 247)

In other words, all cash or its equivalent in excess of immediate operating necessities "belonged to" the General Mortgage Bonds, so, the Circuit Court concludes,

> ". . .the plan of reorganization should have made sure that all excess current assets . . . would go to the General Bondholders." (R. 249)

The General Mortgage Trustee, startled by this golden shower upon the junior creditor, says the Circuit Court does not mean what it says.[51] But its words, we think, remain the best evidence of its intention. However startling that may be, the words say that current assets shall be converted into cash and cash shall be distributed to the most junior lienor though senior lienors are compelled to take new securities, in large part of junior grades and of undeniably doubtful value. Cash is the highest medium of compensatory treatment and surely a more certain means of payment than any new security. To the extent of the cash distributed, such an award transfers the risk of ultimate satisfaction from the junior creditor to the senior, in exact reversal of the priority rule, in any form that it has ever been put.

This should certainly be rectified. But our case does not stop there. Whatever the Circuit Court may have intended as the destination for the surplus cash it conceived to exist, its intention is unjustifiable. Even if the Circuit Court intended a distribution among Senior Creditors, still its design was that an equal par amount of new Common Stock should be taken from the Senior Creditors and given to the Generals. This in itself repudiates the Commission's findings of the equitable equivalent of the present claims, di-

[51] Brief in opposition to certiorari dated August 31, 1945, p. 15.

verts value from the Senior Creditors to the Generals, and breaks down the very limitation that made the Plan legal in the view of the Commission and the District Court. It is, therefore, like the Circuit Court's other allocations of stock to the Generals dealt with in II and III below and unlawful for the same reasons because preventing full satisfaction of Senior Claims.

So the action of the Circuit Court in regard to cash on hand is erroneous from the point of view of private right as well as from the point of view of the public interest, and on both grounds should be reversed so that, in regard to cash on hand, the orders establishing the Plan may be affirmed.

II
DISTRIBUTION OF FUTURE EARNINGS

1. The Circuit Court Invades the Commission's Function which is to Fix a New Capitalization Consistent with the Public Interest.

Evidence of past earnings.—The Commission's task of shaping a new capitalization was not a problem of mere mathematics. It was an exercise of informed judgment on the probable composite result of diverse trends so fundamental as to condition the very ability of the railroads to continue under a system of private ownership. The physical volume of business and the rates to be charged are primary factors on total operating revenues. Operating costs and taxes are primary factors on what will remain for a return on new securities. Innumerable other developments condition these trends or directly affect net earnings. So the Commission's reasoning can not be exposed in a syllogism.

But the past is surely evidential for the future. And in inquiring whether there was evidence to support the Com-

mission's capitalization, the record of past earnings is informative.

The Commission had before it the earnings of the road for the whole period 1915-1942. No doubt, special circumstances typified the years before the termination of Federal control following World War I. But the remaining years supplied a broad base for an intelligent estimate of future prospects. The earnings for nearly all of two more years were before the District Court. So the whole period 1921-1944 was covered, down to what has been identified above as the cut-off date.

Under the prescribed classification of accounts, net earnings available for interest are stated after provision for all taxes, including those based on income. In that matter of income taxes, the recorded earnings available for interest in the past are greater than those to be expected in the future, first because the deductions allowed for interest on the excessive debt capitalization of the past are larger than those to be available on the reduced debt capitalization of the Plan, and next because the tax rates of all but the very recent years of the past are less than those that will probably prevail through the long future. Correction in both respects is a simple calculation once granted the applicable tax rate.

In Appendix F we summarize the earnings in 1921-1944 as applied under the Plan. On the applicable tax rate it is, of course, impossible to be precise. As a general illustration of probabilities, though in no sense an attempt at prophecy, we use a rate of 35%. But to avoid any question on such matters we then show the situation as if there were no Federal income tax whatever.

The results are that, on a 35% tax rate, dividends on the new Common at 6% have not been covered in any year of the whole period except the extraordinary war years of

1942-1944.[82] On the average through the whole period, ~~even~~ Preferred dividends have ~~not~~ hardly been covered, and the result of paying 6% dividends on the Common throughout the period would, without any use of income for improvements, be a deficit of 61 million dollars. Even in the unthinkable condition of no Federal income taxes, Common dividends at 6% would have been covered in only three additional years (1926, 1928 and 1929), and the regular payment of such dividends throughout the period would have left a deficit of 28 millions.

The calculations underlying these figures are not open to mathematical argument or question. They are the officially reported earnings, increased in a substantial amount to reflect the operating economies on the 1940 basis from the improvement program, and applied in the alternative to the approximate present level of income taxes or to a situation where there are no income taxes at all. The earnings are shown in their entirety, without any provision for improvement expenditures, though these averaged 3.3 million dollars a year in the decade 1926-1935[83] and 4.8 a year in 1936-1944.[84]

On that record, we submit, it is impossible to say that there is no evidence to support the Commission's action in fixing the new capitalization as provided in the Plan.

Earlier proposals.—The justiciable question is, of course, only whether the new capitalization actually provided for in the Plan itself is within the Commission's power. The courts do not sit to review any earlier administrative steps along the road to the final result, or the consistency or in-

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[82]The extraordinary level of operations in those years is indicated by the fact that total revenue net ton miles in 1942, 1943 and 1944 were 214.2%, 257.3% and 254.4%, respectively, of the previous peak of 1929. (The revenue per ton mile, however, was only 76.8%, 78.4% and 79.2%, respectively, of the 1929 figure.) See Annual Reports.

[83]R. 735-7 and Ex. 73 (I Tr. 3693).

[84]See Annual Reports.

consistency of the reasoning that accompanies them. This rule is rooted deep in obvious policy and applied broadly throughout the field of administrative law.[85] So the Circuit Court went astray when it gave weight to earlier proposals of the parties themselves (R. 238), for they were not admissions, but on their face mere compromise proposals,[86] and even had they been admissions, they must be deemed ineffective against the statutory command for a fair and equitable plan compatible with the public interest.[87] Nor are the General Mortgage Bonds entitled to any special regard because it took time to solve the problems of the reorganization, thus increasing the amounts due Senior Creditors by the amounts accruing for interest (R. 238, 244, 248-9). That is one of the burdens of civilization, of which all people, and particularly junior creditors, assume the risk. It was for the Commission to formulate a plan and it discharged that duty. It was not obstructed but assisted in the discharge of that duty by suggestions from the Senior Creditors and numerous compromises by them.

Property improvements.—There were questions, no doubt, for the Commission to resolve as to the weight of that evidence, such as the question stressed by the General Mort-

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[85]On the specific point of railroad reorganization plans, see *In Re New York, New Haven & Hartford R.*, 54 F. S. 595, 602 (D. Conn., 1943). As to the powers in general of the Commission and other administrative agencies, see *Virginian Railway* v. *U. S.*, 272 U. S. 658, 663 (1926, I. C. C.); *Tagg Brothers & Moorhead* v. *U. S.*, 280 U. S. 420, 445 (1930, Department of Agriculture); *N.L.R.B.* v. *Baltimore Transit Company*, 140 F. 2d 51 (C.C.A. 4, 1944); *Niagara Falls Power Co.* v. *F.P.C.*, 137 F. 2d 787 (C.C.A. 2, 1943); *Knight* v. *U. S. Land Association*, 142 U. S. 161 (1891, Department of the Interior); *Pearson* v. *Williams*, 202 U. S. 281 (1906, Immigration); *Houghton* v. *Payne*, 194 U. S. 88 (1904, Post Office Department).

[86]*E. g.*, ". . . the inclusion of this suggested compromise offer [R. 604B] is in no sense a waiver of the Committee's position on any issue." (II Tr. 141)

[87]*Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106, 114, 128-9 (1939).

gage Trustee, of the economies from the large improvements to the property. But as the following comments show, these were merely matters for the Commission to appraise.

Certainly there have been large improvements during the proceeding, though the 43 million dollar figure of the Circuit Court (R. 243) does not give the full picture, since it does not reflect retirements and recorded depreciation and amortization during the same period. Reflecting all these matters the net increase in investment was only 8 million dollars from the inception of the proceeding on November 1, 1935, to the stated effective date of the Plan on January 1, 1943.[58] But the Commission was not obliged to increase the new capitalization by an equal amount. On the contrary, the question still was the amount of prospective earning capacity. The mere addition to investment does not automatically raise that level.[59] Though more recent, and thus in point of degree more persuasive than older installations, it is nevertheless relevant only in so far as it "may indirectly bear on earning capacity." (*Milwaukee Case*, 318 U. S. at 541) The Circuit Court purportedly accepts this result, observing that, without the improvements, earning capacity might have been "substantially reduced" (R. 244). It also correctly holds that the wisdom of the expenditures is not in issue here (R. 244), for that could have been raised only in appeals from the authorizing orders, and the General Mortgage Trustee never took any such appeal. But, in the face of these observations, the Circuit Court apparently allows the mere dollar amount

[58] See Annual Reports. There was a further, and equal, net increase in investment between January 1, 1943, and December 31, 1944, but this was made from funds equitably belonging to those who receive the new securities under the Plan.

[59] *Missouri Pacific Reorganization*, 257 I.C.C. 479, 525 (1944).

of these expenditures to override the Commission's administrative judgment on resulting net earning capacity.

Operating Expenses.—On the fundamental question of net earning capacity it is, of course, true that many of the improvements save expenses, as by reducing man-hours of work or unit consumption of materials and supplies. Indications of these effects were put in evidence at the last Commission hearing (R. 840, 1133-35) and are reflected in the above figures. It was largely on that basis that the Commission increased total new capitalization by 8 million dollars.[30] Without this increase, it will be noted, there would have been nothing at all for the General Mortgage Bonds. But reduction in man hours of work, or in consumption of units of materials and supplies, is not the whole story, by any means. Increases in compensation per man hour of work, or in cost per unit of materials and supplies, may leave actual costs unchanged, or even greater, and it is, of course, the actual costs and the actual resulting net that is significant. For many years one of the most pervasive and fundamental trends in the railroad industry has been a seemingly inexorable advance in unit costs. This was emphasized by the Commission as early as its first report on this reorganization in 1939 (R. 44). Since then the evidence shows that wages on this property have increased 30% and the unit costs of materials and supplies 16% (R. 300). The Debtor Trustees estimated that the 1943 wage increase alone added 2.7 million dollars to 1944 operating costs.[31] That equals a 6% return on 45 million dollars, a sum greater than the total additions and betterments during the whole time of the proceeding. It is well known that requests for

[30] Cf. R. 68, 120, 124, 159.

[31] Annual Report 1943, p. 5.

further increases are now presented and in course of consideration. The trend is evident in the following table:[92]

	000's omitted		
	1942	1943	1944
Gross Income	$17,444	$12,305	$10,912
Income taxes	2,180	7,184	5,338
Total (equivalent to earnings available for income taxes and return on securities)	19,624	19,489	16,250
Ry. Operating Revenues	54,475	70,194	70,347

In other words, despite a 15 million dollar increase in Railway Operating Revenues in 1943, the balance for income taxes and return on securities was unchanged; and on the same level of Railway Operating Revenues in 1944, the balance for income taxes and return declined 3 million dollars. The problem presented by these trends is of general concern to railway management.[93]

It was for such reasons that the District Court, with its special opportunities for knowledge of the property, found that the "very large" increase in basic costs "more than offsets the economies effected by the Improvement Program." (R. 218-19) The burden of this increase can be expected to show in unmistakeable terms as the extraordinary volume of war time traffic recedes to a peace economy with the restored and intensified competition it will inevitably bring. A solemn warning is supplied by the Commission's finding in *Missouri Pacific Reorganization*, 257 I. C. C. 479, 526-7

[92] Railway Operating Revenues include all receipts from transportation. Deducting railway operating expenses, income and other taxes and the net payments for car hire and joint facilities produces net railway operating income. Adding income from non-railroad sources produces Gross Income.

[93] See J. J. Pelley, President, Association of American Railroads, quoted in The New York Times, December 27, 1945, p. 25, column 6; R. E. Woodruff, President, Erie Railroad Company, *id.*, January 2, 1946, p. 25, column 2.

(1944) that if the Missouri Pacific income account in 1940 were recomputed on the basis of 1944 unit costs, its 13 million dollars reported net available for interest in 1940 would be changed to a deficit of 11 million dollars. It was natural, therefore, for the Circuit Court to say:

> "It is not unreasonable to assume that if these improvements had not been made, the probable earning capacity would have been substantially reduced." (R. 244)

Rates.—The downward trend of rates on the Rio Grande has been pointed out, but its effect on net earnings is too vital to go unmentioned here. The Rio Grande's greatest net earnings available for interest before the extraordinary war years were in 1926 and 1929. Yet the net earnings available for interest reported in those years, taken together, would have been almost wholly extinguished if the 1944 levels of rates had prevailed at that time.[34]

Liberality of Commission.—These were matters to be weighed by the Commission and it was entitled in their light to find that there is no prospect of a future more brilliant than will accommodate the Plan. The inadequacy of 1921-1944 earnings to cover dividends on the new Common Stock is, especially in the light of the current trends noted above, in itself sufficient evidence to support the Commission's conclusions. Indeed they indicate that the Commission has been liberal, and so it has, more so than its custom in other cases. It may be noticed from the published reports of the Commission that the new capitalization in this case is larger than the average of all other important railroad cases, whether viewed in relation to the largest earnings in any year of the decade 1930-1939 or in relation to the physical

[34] The sum of the net earnings available for interest in 1926 and 1929 would have been reduced from 16.5 million dollars as reported to 1.1 million dollars. See Annual Reports.

values found by the Commission. Moreover, past earnings in this case were appraised not only in the light of a 5% capitalization rate, or 20 times earnings, the Commission's most usual test,[29] but also of a 4% rate, or 25 times earnings. No railroad reorganization under Section 77 has used a more liberal test. It is much more liberal than the Securities and Exchange Commission practice for the more stable electric utility industry.[30] The District Court was troubled on this score, saying

> ". . . it is very doubtful to my mind if the new capital structure is not too large" (R. 1065).

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[29] *E. g.*:

Chicago Great Western R. Co. Reorganization, 228 I. C. C. 585, 611-12 (1938), 233 I.C.C. 63 (1939); approved *In Re Chicago Great Western R. Co.*, 29 F. S. 149, 160 (N. D. Ill. 1939);

Akron, Canton & Youngstown R. Co. and Northern Ohio R. Co. Reorganization, 228 I. C. C. 645 (1938), approval affirmed *Akron, Canton & Youngstown R. Co.* v. *Hagenbuch*, 128 F. 2d 932, 937-8 (C. C. A. 6, 1942), *cert. den.* 318 U. S. 794 (1943);

Chicago and North Western R. Co. Reorganization, 236 I. C. C. 575, 628 (1939), 239 I. C. C. 613 (1940), approved *In Re Chicago and North Western R. Co.*, 35 F. S. 230 (N. D. Ill., 1940), *aff.* 126 F. 2d 351 (C. C. A. 7, 1942), *cert. den.* 318 U. S. 793 (1943);

New York, New Haven and Hartford R. Co. Reorganization, 239 I. C. C. 37, 97-8 (1940), 244 I. C. C. 239 (1941), 254 I. C. C. 63 (1942); 254 I. C. C. 405 (1943), 257 I. C. C. 9 (1944), approved *In re New York, New Haven and Hartford R.*, 54 F. S. 595, 601 (D. Conn. 1943), 54 F. S. 631 (D. Conn. 1944), *aff.* 147 F. 2d 40 (C. C. A. 2, 1945), *cert. den.* —— U. S. ——, 89 L. ed. 1553 (1945);

Erie R. Co. Reorganization, 239 I. C. C. 653, 716-17 (1940), 240 I. C. C. 469 (1940), approved *In Re Erie R. Co.*, 37 F. S. 237 (N. D. Ohio 1940).

[30] *Portland Electric Power Co.*, S.E.C. Holding Company Act Release No. 6365, Jan. 15, 1946, at p. 17 (8 1/3%); *York Railways Co.*, Release No. 6285, Dec. 11, 1945, at p. 17 (5.6%); *International Utilities Corporation*, Release Nos. 4896, Feb. 15, 1944, and 4992, April 14, 1944 (8%); *Stanley Clarke*, Release No. 4985, April 15, 1944 (8-11%); *Columbia Gas and Electric Corporation*, Release No.

Similarly Trustee Swan, in the greatest earnings year of all history, testified:

> "Our problem is: what will the Trustees do to make possible an earning capacity to justify the Interstate Commerce Commission Plan? This is a fact. This is no theory." (R. 1006)

Circuit Court's Action.—This is the record on which the Circuit Court requires the Commission as a matter of law to *increase* the capitalization provided for in the Plan. It does this by directing that "all excess war profits yet to accrue" shall go to the General Mortgage Bonds (R. 247, 248, 249) and that for all later time any "greater net returns than anticipated in the plan" shall go to the General Mortgage Bonds (R. 250). Any such right of participation in future earnings is a security, and the particular legal form that may be chosen to evidence it is a matter of no consequence. The Circuit Court recognized this by suggesting for the Generals an additional issue of "a subordinate stock which would receive returns only from excess dividends" (R. 250), subordinate, that is, to the new Common Stock. The Circuit Court admitted that the particular method of arranging this participation was for the Commission to determine, but since no securities can possibly be taken from the Senior Creditors, an increase in total new capitalization is the inevitable consequence of the decision if it should stand.

It is remarkable, we think proper to say, that an appellate court, rightly declaring that the Commission's action "in

3885, Nov. 10, 1942 (8%); *Derby Gas and Electric Corporation*, Release No. 2985, Sept. 6, 1941 (about 7%); *Mountain States Power Co.*, 5 S. E. C. 1, 7 (1939) ("7% or even 6%"); *Northern Indiana Public Service Co.*, 5 S. E. C. 239 (1939) (6%); *Utilities Power and Light Corp.*, 5 S. E. C. 483 (1939) (5.25% on a consolidated basis). See also *Massachusetts Utilities Associates*, 5 S. E. C. 88 (1939) (gas; 5%), and *Peoples Light and Power Co.*, 5 S. E. C. 461 (1939) (gas; 6 2/3%, 7% and 8%).

fixing the valuation and setting up the capital structure is free from . . . infirmities, and . . . must be upheld" (R. 245), should immediately require an important increase in that capital structure. The remarkable nature of this action is not diminished by the fact that it is the first time any court has overridden the Commission's judgment on the total amount of the permissible new capitalization, or by the fact that the stage for this innovation is a case where historical earnings have been seriously inadequate to provide a fair return on the new securities already called for in the Commission's Plan.

The Circuit Court's action should be reconciled with its declaration by reversal. As this Court said:

> "So long as legal standards are followed, the judgment of the Commission on such capitalization is final." (*Western Pacific Case*, 318 U. S. at 474)

> "The basic question in a valuation for reorganization purposes is how much the enterprise in all probability can earn . . . Certainly there is no constitutional reason why earning power may not be utilized as the criterion for determining value for reorganization purposes. And it is our view that Congress when it passed §77 made earning power the primary criterion." (*Milwaukee Case*, 318 U. S. at 540-41)

War Earnings.—The only imaginable basis for a view that there was no evidence to support the Commission's action, or that it applied an erroneous standard, would be that the peak earnings of war-time must be accepted as the norm for the future. But the Circuit Court itself disclaimed such an approach, saying that

> "These earnings are to a great extent artificial, and will disappear largely with the coming of the peace. They have very little value in estimating the probable future earnings of this property in the peace economy

which is to come. The Commission was well within its right in largely disregarding them . . ." (R. 242)

This was also the express view of the Commission[97] and the District Court[98] and is in accord with this Court's admonition that

". . . the bulge of war earnings *per se* is unreliable for use as a norm unless history is to be ignored . . ." (*Milwaukee Case*, 318 U. S. at 543)[99]

The record here precludes the possibility of any different view.

So it is immaterial that war-time earnings have been so high as to make up for regular failure of the road to earn interest on the Senior Debt in all the years of the reorganization proceedings before 1942, and indeed to leave a substantial amount of reported earnings for the whole elapsed period of the proceeding in excess of interest on the Senior Debt (R. 349). That merely dramatizes the spectacular extent of the non-recurring and non-capitalizable war-time earnings. Nor can the General Mortgage Trustee assert any special claim to additional new securities on this account

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[97]R. 158-9, quoted at p. 20 above. The Commission has repeatedly expressed similar views in other cases; see *Chicago, Rock Island & Pacific R. Co. Reorganization*, 257 I.C.C. 265, 286 (1944), *St. Louis-San Francisco R. Co. Reorganization*, 257 I.C.C. 399, 409 (1944); *Missouri Pacific Reorganization*, 257 I.C.C. 479, 522-27 (1944).

[98]R. 192, 194, quoted at p. 22 above, and R. 219-20, summarized at p. 24 above.

[99]The same view has been repeatedly taken here and in the lower courts; see:

Western Pacific Case, 318 U. S. at 508-9 (1943);
I. C. C. v. Jersey City, 322 U. S. 503 (1944);
In re New York, New Haven & Hartford R., 147 F. 2d 40, 45-6 (C. C. A. 2, 1945), *cert. den.* —— U. S. ——, 89 L. ed. 1553 (1945);
In re Chicago, Milwaukee, St. Paul & Pacific R., 145 F. 2d 299, 303 (C. C. A. 7, 1944).

because of any view of a lien on impounded income. All income was subject to the prior liens of the Senior Debt both by seasonable sequestration petitions and by mere possession of the Debtor Trustees,[1] and 77 million dollars of principal of Senior Debt had matured in addition to the 16 million of interest to January 1, 1943, a sum approximating twice the total net available for interest on funded debt reported since the inception of the proceeding.

These considerations, we submit, require that the Circuit Court should be reversed in so far as it requires changes in the Plan because of future earnings, in order that, in this respect also, the orders establishing the Plan may be affirmed.

Peril to Public Interest.—This is not a case where adherence to established procedure is important only to avoid the possibility of evils in other cases, for the Circuit Court's action directly obstructs the public interest in the capitalization of this property.

The purpose of the Congress in the enactment of Section 77 was to remove, rather than perpetuate, the causes of bankruptcy.[2] It is well known that unsound financing through persistent increase in debt has been a major cause of the chronic financial difficulties of the railroads, and that the only alternative, where new money is needed, is sale of stock.[3] This is possible only where the quantity of stock is so limited in relation to earnings as to give it an investment quality. Such limitation, and the preservation of a genuine possibility of equity financing, are thus matters that "affect

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[1] *Central Hanover Bank and Trust Co. v. Philadelphia & Reading Coal & Iron Co.*, 99 F. 2d 642, 645 (C.C.A. 3, 1938); *In Re Philadelphia & Reading Coal & Iron Co.*, 117 F. 2d 976, 978 (C. C. A. 3 1941).

[2] H. R. Rep. No. 1336, 74th Cong., 1st Sess. (1935) 6.

[3] Commissioner Eastman dissenting in *Chicago, Milwaukee and St. Paul Reorganization*, 131 I. C. C. 673, 701 (1928).

the public interest immediately and directly.'" The Commission was alive to the realization of both those purposes in this case and acted "so as to facilitate the use of stock in future financing." (R. 69)

The illusory sub-common stock that the Circuit Court conceives beyond the visible reach of earnings could have no investment attributes. It would be a mere speculative token, and its very existence, draining off the earnings of prosperous years, would degrade the new Common, for in that state of affairs the new Common could never recoup the losses of bad years from the "excess" earnings of prosperous years. Thus the new Common would in effect become a second preferred stock; at a point in earnings that would give it deceptive potentialities in the market. This limitation of return might also have serious consequences on the incentive to effective corporate management.

The problem of voting power for the new sub-common stock carries an equal menace. If it has no vote, it will be scandalous; if it has a vote, it will displace, in some degree, effective control from the area of effective ownership, with the evils that notoriously follow.

So in multiple respects exact obedience to the Circuit Court would disrupt sound financial practice. Approximate obedience to the Circuit Court through the means of an enlarged issue of the new Common itself would also involve many of these same disadvantages. As the Commission recently said:

> "If the amount of junior securities of a company is far in excess of its expectable earning power, additional securities of that character must be sold, if sold at all, at prices which are prohibitive, taking into consideration the amount of cash which would have to be raised and the plant additions to be financed. Reorganizations

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'*Western Pacific Case*, 318 U. S. at 474.

should remove rather than perpetuate the cause of bankruptcy, and should not be a means of misleading old and new investors. That desired effect can result only if the new securities are so related in character and total amount to the ability of the reorganized company to pay interest and dividends, that such securities possess an actual value and not merely one that is speculative." (*Missouri Pacific Reorganization*, 257 I. C. C. 479, 524 (1944))

The public interest sought to be safeguarded by the limitations on appellate action, is thus directly in peril from the action of the Circuit Court.

2. The Circuit Court Defeats the Private Right to Full Satfaction.

(a) Introduction

Here we invoke the private right of the Senior Creditors to be made whole before the General Mortgage Bonds can have any substantial participation, a right which the Circuit Court's decision will defeat.

This private right is invoked not only for its immediate importance to the Petitioners, but also for its consequential importance to the railroad industry and the public. Through all history the railroads have obtained substantial parts of their necessary capital in the form of senior debt, where capital is supplied for a fixed return, without hope of incremental profit, relying on the right to be made whole in an actual and realistic sense before any provision for junior interests. To protect the availability of such credit on cheap terms for the future it is important that the agreed protection be supplied in actual practice as well as by abstract pronouncement.

(b) The Absolute Priority Rule

Prior to the corporate reorganization acts the repeated pronouncements of this Court that stockholders can have

nothing "until all the debts of the corporation are paid"[5] were translated in many reorganizations into a doctrine of relative priority. This said that, so long as the relative positions of the respective classes of old claims were substantially maintained, either in stratified form through a qualitative recognition of priorities in different grades of new securities (which the Circuit Court attempts here by its new sub-common stock) or in commuted form through a quantitative recognition of priorities in different amounts of the same grade of new security, all classes of old claims might be recognized, without regard, or largely without regard, to the value of the realization so provided. This doctrine made possible the continuation of all the old classes even though the senior ones were not made whole, and led to the creation of excessive new capitalizations.[6] On the other hand there were those who, mindful that the creditor's contract is one to be paid,[7] and not merely to be better off than someone else, believed that it was not enough to give him for his old debt new securities of an equal face amount regardless of their value, but each creditor, in his order of rank, must receive new securities having a fair value approximately equal to his total claim before any junior claimant might be recognized. This was the doctrine of absolute priority.

The asserted doctrine of relative priority, on which the Circuit Court seemingly rests here, has now been rejected in categorical terms by this Court and the doctrine of ab-

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[5] *Chicago, Rock Island and Pacific R.* v. *Howard*, 7 Wall. 392, 410 (U. S. 1868); *Louisville Trust Co.* v. *Louisville, New Albany & Chicago R.*, 174 U. S. 674 (1899); *Northern Pacific R.* v. *Boyd*, 228 U. S. 482 (1913).

[6] Moulton and Associates, *The American Transportation Problem*, (1933) pp. 349-52.

[7] This right, and the related interests of the security position, are constitutionally protected: *Louisville Joint Stock Land Bank* v. *Radford*, 295 U. S. 555 (1935); *Wright* v. *Vinton Branch*, 300 U. S. 440 (1937).

solute priority established. In *Case* v. *Los Angeles Lumber Products Co., Ltd.*, 308 U. S. 106 (1939), the Court, in accordance with the arguments of the Interstate Commerce Commission and the Securities and Exchange Commission that contracts have "an unreal quality" unless the creditor receives "recognition approximating full payment",[8] held that creditors are "entitled to be paid" and not merely to retain a superior position irrespective of actual realization (pp. 119-20).

This was made even clearer in *Consolidated Rock Products Co.* v. *DuBois*, 312 U. S. 510 (1941). There the plan gave the bondholders new securities of a face amount equal to the whole of their principal (half in income bonds and half in preferred stock), but made no provision for their unpaid interest, and at the same time recognized the old stock (the old preferred in new common and the old common in warrants). There was no adequate determination in the trial court of reorganization value.[9] The Court held that the confirmation of the plan was erroneous. "The full and absolute priority rule" of the *Boyd Case* and the *Los Angeles Case*, it held, precludes any participation by equity interests "until the bondholders had been made whole" (520-1). They could not be properly taken as "made whole" in that case because they received nothing for their unpaid interest and, quite apart from that, for two additional reasons:

(a) There was no adequate finding of value, and such a finding, in terms of prospective earnings, is essential to a determination of fairness:

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[8] Brief in that case for the United States, *amicus curiae*, at pp. 17 and 25.

[9] For the whole property, with which we are here concerned, or of the component parcels; a matter of no interest here. Since the Company was an industrial, no commission action was required.

"Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a *sine qua non* to a determination of the integrity and practicability of the new capital structure. It is also essential for satisfaction of the absolute priority rule of *Case* v. *Los Angeles Lumber Products Co.*, *supra*. Unless meticulous regard for earning capacity be had, indefensible participation of junior interests in plans of reorganization may result." (525-6)

(b) The bondholders were not compensated for their surrender of senior rights in receiving the new junior securities:

"True, the relative priorities are maintained. But the bondholders have not been made whole. They have received an inferior grade of securities, inferior in the sense that the interest rate has been reduced, a contingent return has been substituted for a fixed one, the maturities have been in part extended and in part eliminated by the substitution of preferred stock, and their former strategic position has been weakened. Those lost rights are of value. Full compensatory provision must be made for the entire bundle of rights which the creditors surrendered." (527-8)

". . . while creditors may be given inferior grades of securities, their 'superior rights' must be recognized. Clearly, those prior rights are not recognized, in cases where stockholders are participating in the plan, if creditors are given only a face amount of inferior securities equal to the face amount of their claims. They must receive, in addition, compensation for the senior rights which they are to surrender. If they receive less than that full compensatory treatment, some of their property rights will be appropriated for the benefit of stockholders without compensation. That is not permissible." (528-9)

The test to govern these questions of compensation was made clear in these words:

> ". . . whether in case of a solvent company the creditors should be made whole for the change in or loss of their seniority by an increased participation in assets, in earnings or in control, or in any combination, thereof, will be dependent on the facts and requirements of each case. So long as the new securities offered are of a *value* equal to the creditors' claims, the appropriateness of the formula employed rests in the informed discretion of the court." (529-30, italics added.)

In other words, any set of new rights will be adequate compensation for the old if of "a value equal to the creditors' claims," but no set of new rights can be unless it is of that value.

This holding, we submit, clearly settles the law. It was supplemented in the two railroad cases, which are the latest important decisions in this field.

In the *Western Pacific Case*, the Court expounded the absolute priority rule as requiring that:

> "senior claims first receive securities of a worth sufficient to cover their face and interest before junior claims receive anything." (318 U. S. at 483).

This is a holding in terms that the absolute priority rule theretofore laid down as between creditors and stockholders applies equally as between senior and junior classes of creditors, the exact situation presented in the case at bar. Similarly it was held in the *Milwaukee Case:*

> "The rule of the *Boyd* case 'protects the rights of senior creditors against dilution either by junior creditors or by equity interests.' *Marine Harbor Properties* v. *Manufacturers Trust Co.*, [317 U. S. 78, 87]" (318 U. S. at 569).

On the standard of value, the Court in the *Milwaukee Case* said:

> "Only 'meticulous regard for earning capacity' . . . can afford the old security holders protection against a dilution of their priorities and can give the new company some safeguards against the scourge of overcapitalization." (541)

As applied to the question whether the old stock may be recognized, that standard puts the question:

> "whether there is a reasonable probability that the earning power of the road will be sufficient to pay prior claims of interest and principal and leave some surplus for the service of the stock." (541)

On the question of compensation for surrender of senior rights the Court in the *Milwaukee Case* reaffirmed the rule in the *Rock Products Case*, pointing out that:

> "Unless that principle is respected, there will be serious invasions of the rights of senior claimants to the benefit of junior interests. The property of one group will be subtly appropriated to pay the claims of another while lip service is rendered the principles of priority." (570)

It is, therefore, settled that senior creditors must be made whole by receiving new securities with a value approximating their total claim before any junior interest may be recognized.

(c) The Test of Value

"Value" is, of course, a word of many meanings (*Milwaukee Case* at 540), but the use here of that term, or of the Court's other term "worth", does not raise any new problems or any further obscurity. It is clearly designed

to mean something that makes the creditor "whole" by giving him "completely compensatory" treatment in a sense that a practical man of affairs can understand. That necessarily means new securities approximately equivalent to a payment in cash.

There is room for a good deal of elasticity in the time as of which that "value" is determined. The most rigid view would be spot market value at the time of issuance.[10] But this would permanently rearrange ownership on the basis of conditions that chanced to exist at a particular moment, even though those conditions might reasonably be judged temporary, and thus impose undue sacrifices, which were not the purpose of the Act.[11] The equitable rule implicit in the decisions of this Court, we submit, is that reorganization value is to be determined on the basis of the earning power that appears to be the reasonably assured expectancy. The Court's test of "reasonable probability" quoted above from the *Milwaukee Case* is an illustration, and further in point as emphasizing that the value of the distributed securities, and not the value of the assets, is the controlling criterion. If the creditor can not realize that value now, but only later, the rule itself requires a high degree of real assurance.

The creditor may not complain that he has to wait if the period of waiting is not so long as to endanger ultimate satisfaction in full. Nor may the junior interest complain if the creditor is merely getting his agreed treatment. But the creditor is entitled to complain if he is put in risk of loss by postulations of an indefinite future. And the junior interest is not entitled to protection at the cost of shifting the risk of loss from himself to his senior.

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[10] This view has, indeed, been expressed: Dean, *A Review of the Law of Corporate Reorganizations* (1941) 26 Cornell L. Q. 537, 559, n. 63.

[11] S. Rep. No. 1336, 74th Cong., 1st Sess. (1935) 3.

This "reasonable probability", therefore, does not look to spot market at moment of issuance, but it must look to conditions of which the evidence provides reasonable assurance within the reliable future. We do not seek a nice precision of equivalence, for in judgments of future probabilities "'an estimate, as distinguished from mathematical certitude, is all that can be made'" (*Milwaukee Case* at 542). Nor do we contemplate the delusive exactitude of detailed findings of future markets, for that would only afford "an apparent certainty . . . which does not exist in fact." (*Milwaukee Case* at 562) But lest the absolute priority doctrine evaporate into metaphysics, it is essential that its touchstone remain as realizable value, not a mere balancing of investment attributes in the abstract, but an appraisal of them in the light of what people will probably pay. As the Circuit Court of Appeals for the Second Circuit said:

> "Value depends on what people will pay . . ." (*In re New York, New Haven & Hartford R.*, 147 F. 2d 40, 48 (1945) *cert. den.* —— U. S. ——, 65 S. Ct. 1577, 1578 (1945))

It is only when people will probably pay the full amount at which the new securities are used to satisfy existing debts that creditors are "made whole" in the realistic sense intended by this Court, and only when this probability looks to a time reasonably close to the date of exchange and not to the clouds of the distant, and thus conjectural, future.

(d) These Principles Are Violated by the Circuit Court

The Commission found that "the value of the combined properties for the purposes of this proceeding is approximately $155,173,127" (R. 159). But this was apparently

done with a considerable view to "maximum limits".[12] It does not seem that the Commission had any expectation of a market value for each class of the new securities approximating their face amount at any reasonably near date. Indeed, there are indications to the contrary. Its finding on total capitalization was only that it "should not exceed approximately that amount" (R. 159). And it held that RFC, with its award of new First Mortgage Bonds and new Income Bonds for the full amount of its claim, was "not fully secured" and was thus entitled to realize also on its rental claim (R. 178). With respect to the stock to be issued by the reorganized company it said in its first report that the new debt should be so limited "as to render the payment of dividends probable, at least on the new preferred stock, under normal conditions of business" (R. 68). This implies that the Common must look to periods of exceptional railroad prosperity for its return, the very periods, it will be noted, when the Circuit Court channels off all "excess" earnings for the General Mortgage Bonds. The meaning is only that the new Common has "some prospect" of value.[13]

So the Commission did not, we believe, make any finding that the new Common Stock was the equivalent of money in its face amount, presently or at any assured future time. Rather it based its finding of adequate compensation to the Senior Claims on the particular provisions of the Plan, saying that:

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[12] *Opening Journal Entries for Reorganization of Chicago Great Western R. Co.*, 247 I.C.C. 193, 195-6 (1941), reannounced as of general application in *Missouri Pacific Reorganization*, 257 I. C. C. 479, 522 (1944).

[13] Thus *Chicago, Indianapolis & Louisville R. Co. Reorganization*, 254 I.C.C. 539, 565 (1943) and *Alabama, Tennessee & Northern R. Corp. Reorganization*, 247 I.C.C. 453, 465 (1941). Since prospects are always reflected in the market, this contemplates some actual present value (*Missouri Pacific Reorganization*, p. 69 above), though considerably less than par (*Chicago, Rock Island & Pacific R. Co. Reorganization*, 257 I.C.C. 265, 278 (1944)).

"the compensation to the . . . [Senior Creditors] would be adequate under the provisions of the plan . . ." (R. 169)

From the point of view of the new Common Stock, the pertinent "provisions of the plan" are that the new Common Stock represents all that may be left of reorganization value and all of it except 10% is given to the Senior Creditors. This participation for the Generals is not large enough to raise any important issue and no objection to it is presented in these appeals.

There can be no doubt that the District Court followed similar reasoning, for its view of the Common Stock was a somber one. Indeed it said, as shown above, that the new Common "has little or no value" (R. 220), and, if any, then wholly because of the improvement work and the increase in current assets (R. 222).

The Circuit Court breaks down each of these justifications for the Plan. It changes the capitalization so that the new Common provided for in the Plan no longer represents the whole residual equity. Then it diverts the newly required additional securities from the Senior Creditors to the Generals. Thus it takes from the Senior Creditors the present value of a chance to be made whole out of the high earnings of prosperous years in the future, as it has already taken from them the present value of the cash on hand.

This invasion of the Commission's function to determine values[11] can not be justified under a fiction that only a pure question of law is involved (R. 253). Prospective earning capacity is as straight an issue of fact as present cash requirements. Nor can it be justified on the view that exceptionally prosperous years were omitted from the Commission's consideration. It was the Commission's duty, in concluding that the new Common had some prospect of value, to consider the likely results in extraordinarily good years

[11] *Western Pacific Case*, 318 U. S. at 473.

as well as those in extraordinarily bad years, for the long future includes both. That it did so is in terms found by the Circuit Court (R. 242) and it is plain from the Commission's reports that it is precisely the earnings of extraordinarily good years that alone give any prospect of value to the new Common.

So the decision is a frontal attack on the Commission's powers, and a substitution of the Court's own judgment on the amount of the new capitalization. This is made in a case where there was evidence to support the Commission's conclusions. The earnings record, as we have pointed out, shows nothing available for the new Common already provided for in the Plan except in the extraordinary conditions of war-time, which are admitted in the Court's own opinion to be both temporary and non-recurring (R. 242). No heed is given to the relentless march of operating costs, which the District Court found were of such extent as "more than offsets the economies effected by the Improvement Program" (R. 218-19), and which the Circuit Court itself observed to leave less net earnings from greater total operating revenues in 1943 than in 1942 (R. 244). There is no reference to the impact of such new costs on the lower total operating revenues of peace-time that the Circuit Court itself expects. The Commission's finding which the Circuit Court sets aside in the face of this evidence is fundamental to the validity of the Plan. The result is to take from the new Common of the Senior Creditors its only hope of value by diverting to the General Mortgage Bonds the exclusive claim, or an enhanced share, in the high earnings of prosperous years.

This, we submit, erodes all meaning from the "full and absolute priority rule" laid down by this Court. Without pretense of any finding that Senior Creditors will really and actually be made whole, the Circuit Court appropriates the property of one group to pay the claims of another.

There can be no logical explanation of such action except

a theory that otherwise the Senior Creditors would receive more than the amount of their claims. This is contrary to the findings of the Commission and the District Court and there is no evidence to support such a view. Indeed that they can not in fact receive more than their claims is clear on any realistic analysis of earning prospects.

On that point the quotations on the when-issued market are an illuminating supplement. The new securities provided for in the Plan are regularly sold over the counter on a when-issued basis and quotations are regularly reported in the standard financial journals. It is proper to take judicial notice of them.[15] We do not, of course, refer to them as conclusive proof of value, nor do we invoke any theory of spot market value as a test of satisfaction. But as independent, though inconclusive, judgments, they are useful for general indications. They appraise the new Preferred between a half and two-thirds of its par amount, and the new Common between a quarter and a third of its par amount.[16] Even at the highest prices, the Senior Creditors who receive any of the new Common will, on the average, realize, from all their new securities, less than two-thirds of their total

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[15]Thus, in *Wallace* v. *Franz*, 68 F. 2d 313 (C.C.A. 8, 1933) the court took judicial notice of market quotations after the closing of the record below. More recently it has been said in railway reorganizations:

> "We may take judicial notice of the fact that neither stock has substantial market value and has not for five years" (*In re Chicago, Milwaukee, St. Paul & Pacific R.*, 124 F. 2d 754, 762, n. 1 (C. C. A. 7, 1942) *aff.* in *Milwaukee Case*, 318 U. S. 523 (1943)).

> "We must take judicial notice of the fact that most of them [the bonds], during the last five years have sold at around 10¢ on the dollar. Not one of them has sold at or near par" (*In re Chicago and North Western R.*, 126 F. 2d 351, 367 (C. C. A. 7, 1942) *cert. den.* 318 U. S. 793 (1943)).

[16]The exact figures are shown in Appendix G, both for market prices of the new securities and for resulting realization on the present securities.

claim, and one of them will receive only about half its total claim.

This is generally typical of the reorganizations that have been completed, for with only one exception, as the following table shows, the new Preferred and Common stocks have not sold as high as the par or stated amounts at which they were distributed in the respective plans:

	Preferred		Common	
Road	*Par or Stated Amount*	*Highest Market in 1945*	*Par or Stated Amount*	*Highest Market in 1945*
C&EI	$ 40	$26	$ 51.09	$12⅝
CGW	50	34¼	50.00	12½
CMSt.P&P	100	74	100.00	33
C&NW	100	76⅞	100.00	49½
Erie	100	86	40.00	20½
W. P	100	92	57.00 and 62.00	57⅛

There is, accordingly, no basis for any thought that the Senior Creditors will be overpaid. The action of the Circuit Court in requiring additional securities for the General Mortgage Bonds representing an enhanced share in future earnings subverts the "full and absolute priority rule" and should be reversed so that, in that respect also, the orders establishing the Plan may be affirmed.

III
EQUIPMENT TRUST OBLIGATIONS AND JUNCTION BONDS

(a) Introduction

Since the stated effective date of the Plan and the Commission's approval of it, two issues of senior debt have been paid or acquired, in whole or in part, by the Debtor Trustees. Thus cash that would otherwise remain among the assets of the estate has been disbursed and the initial debt capitalization under the Plan has been reduced by an equal amount, leaving net worth unchanged. In both instances the Circuit Court held that an equal face amount of additional new securities must be issued, contrary to the plain terms of the Plan. For brevity, both questions may be discussed together.

(b) The Facts

The facts are that on January 1, 1943, the stated effective date of the Plan, $5,758,000 aggregate principal amount of equipment trust obligations were outstanding, all issued by the Debtor Trustees.[17] These matured serially in the aggregate principal amount of $609,000 a year.[18] The Debtor Trustees met these maturities when due. So $1,218,000 principal amount were paid in the two years 1943-44.

The Plan provides that:

> "The capitalization of the new company, as of January 1, 1943, after consummation of the plan . . . shall consist substantially of the following securities . . . the amounts stated being subject to reduction to the extent, if any, that matured interest proposed to be funded in

[17] R. 182, Annual Report 1943, pp. 13 and 15.

[18] 1 Tr. 5018 (1942 Ct. Ex. 7).

the plan is paid, and as equipment obligations or other liabilities are paid or reduced . . ." (R. 2-3)

The other debt in question was the Rio Grande Junction Bonds, with a total claim for principal and interest to January 1, 1943, of $2,758,333 (R. 183), secured by a first lien on 62 miles of the main line in Colorado that are owned by a subsidiary and leased to the Rio Grande (R. 38). As stated at p. 22 above, a contention had been made in the proceedings before the Commission that these bonds were not subject to modification in bankruptcy because the Junction Company was not a party to proceedings under Section 77. To avoid any delay on this account in the consummation of the rest of the Plan, the Commission provided that the District Court might exclude the Junction Company from the Plan and consummate the rest of the Plan independently.[19] The controversies arising on this point before the District Court at the hearing on approval of the Plan made it evident that delay might well ensue unless it should avail of this permission. So it did. Expressly relying on this provision of the Plan and the further provision by which the District Court was empowered to construe the Plan and cure defects, the District Court caused the Debtor Trustees to purchase the Junction Bonds at their principal plus interest accrued at their coupon rate (R. 199-201). Recognizing that the Junction Company was excluded from the Plan by this action, the Commission did not submit the Plan to the Junction bondholders (R. 28). In result the reorganized company will receive all securities of the Junction Company and will thus be in a position to take over its assets.

In both instances the Circuit Court held that the "new securities set apart for the payment" of the old debt[20] would

[19] R. 166 and 2.

[20] "New securities" were in fact provided only for the Junction Bonds. The equipment trusts were to be assumed.

not be needed and, since the Senior Claims "had been paid in full";

> "... this undistributed value [in respect of the Junction Bonds] in all equity and fairness belongs to the General Bondholders. Any plan which does not give it to them does not comply with the requirements of Section 77(e) of the Act." (R. 251)

> "This unused value [as to the equipment trusts] belongs to the General Bondholders." (R. 251)

By the previous discussion in this brief we have shown that the Plan, apart from these two points, was within the powers of the Commission and the District Court and is thus conclusive in the Circuit Court. On that premise we now inquire whether the Circuit Court had the power to require modifications of the Plan because of these two points. We submit that it did not and that its action is illegal for two reasons: (*i*) as usurping the Commission's power to fix the new capitalization in the public interest and (*ii*) as usurping the Commission's power to provide full satisfaction for private rights.[21]

(c) The Public Interest

The Plan provides for much more initial debt than the Commission had previously thought permissible, indeed 11 million dollars more.[22] The improvements that had been made were an aid to this action (R. 118-119), but so was present and prospective cash, for it was expected, apart from covering the needs of operation and providing a fair return on the new securities, to flow into further

[21] No question arises here whether the Junction bondholders received too much by the purchase, for that question could have been presented only in appeal from the order directing the purchase, and none was taken.

[22] *Cf.* R. 184 and R. 352.

improvements.[23] It was, in other words, the whole bundle of assets to which the Commission looked in finding reorganization value. So if cash should be paid out on old debt dealt with in the Plan, it was understandable that the Commission might require the new debt to be correspondingly reduced. It knew, of course, that such payments would be made on equipment trusts, for they were all issued by the Debtor Trustees, with serial maturities that were being regularly met. Conceivably, also, similar payments might be made on other debt dealt with in the Plan. So the Commission provided in the Plan that any reduction of "equipment obligations or other liabilities" should reduce, by an equal amount, the new capitalization (R. 2-3).

The contingencies so provided for having occurred, the new capitalization under the Plan is the amount fixed by the new state of affairs and thus excludes provision for the paid equipment trusts and the purchased Junction Bonds. As to the equipment trust obligations, no new securities were ever provided for them, but there was merely to be an assumption of those at the time outstanding. There being a smaller amount, the only consequence is that the smaller amount alone is to be assumed. Similarly on the Junction Bonds, the provisions for the Junction Company having been excluded from the Plan, there are no provisions in the Plan for an issuance of new securities in that respect. The situation is merely that the Debtor Trustees have invested a part of their funds, choosing, in lieu of additions and betterments, for example, the bonds of the Junction Company.

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[23] Thus see R. 155-158. The evidence indicated that from the cash on hand at January 1, 1943, or thereafter received, about 14 million dollars was to be used to pay for improvements to the property (R. 1021-22, 1186). A further improvement program was also expected (R. 1028).

Under the general rule of administrative action (p. 57 above), it is the result that matters, and not the intermediate steps by which it is reached. The question is whether it was within the power of the Commission to limit new capitalization to the amount presently and effectively provided for in the Plan. That question is controlled, of course, by the earnings prospects. They have been discussed above. All that discussion has omitted, from the requirements to service the new securities provided for in the Plan, all equipment trust obligations and all the new securities originally provided for the Junction Bonds. Even so, historical earnings have been inadequate, except in the war years, to provide a fair return on the remaining new securities that will be actually issued, and mounting levels of costs put problems for the future. Plainly, therefore, there was evidence to support the Commission's action. This is decisive. Yet the Circuit Court, overriding the express limitation in the Plan, requires the issuance of additional new securities in lieu of those paid or purchased, though the cash so used is no longer there and the equipment has depreciated. To issue the original debt on reduced assets is to increase capitalization as surely as to issue greater debt on the original assets. Both dilute the ratio of security. Such action is, accordingly, beyond the Circuit Court's appellate jurisdiction.

Some considerable latitude of discretion must, as a practical matter, be allowed the Commission in these decisions. For one thing, there is no formula to produce precise answers in such areas of judgment. Indeed any such approach would only "create an illusion of certainty where none exists" (*Milwaukee Case*, 565). But what is more, the railroads do a continuous job and every day brings some degree of change. As an illustration, we suggest that the Debtor Trustees are now engaged in issuing $2,610,000 of new equipment

trust certificates, a sum twice as large as the reduction considered by the Circuit Court.[4] Other changes will no doubt occur. The concepts of the law must not be drawn too fine for the accomplishment of the practical task. If any substantial change were allowed to invalidate a plan, it might well prove impossible to complete the reorganization of any railroad. As the Court has said, interpretations that would place "an impracticable burden on the whole reorganization process" (*Milwaukee Case* at 565) are to be avoided.

(d) Private Right

It may well be that the words of the Circuit Court intend that the General Mortgage Bonds shall receive new bonds equal to those originally provided for the Junction Bonds and equal to the amount of the equipment trusts that have been paid. If so, that is another glaring defiance of the priority rule, comparable, though somewhat less extreme, to its award to them of cash discussed at p. 53 above, for the Plan requires the Senior Creditors to take new Common Stock for a substantial part of their total claim. But even if the words of the Circuit Court contemplate some increase in the allotment of new bonds to the Senior Creditors, and a transfer of an equal face amount of new Common Stock to the Generals, that also, we submit, is a violation of the right of the Senior Creditors to full satisfaction of their claims.

The Plan being validly established by the concurring action of the Commission and the District Court, all junior security holders cease to have any interest in the property except, in the case of the General Mortgage Bonds, the limited participation allotted them in the Plan. Thereafter it

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[4] *Denver and Rio Grande Western Railroad Company Trustees Equipment Certificates*, F. D. No. 15,046, Oct. 16, 1945, —— I. C. C. —— and Order herein by the District Court dated November 9, 1945.

makes no difference how the elements of value to which the Commission and the District Court looked in this determination may be shifted from one form to another, for in each successive form they remain the property of those who receive the new securities under the Plan. Thus, if cash is invested in improvements to the property, as is in fact done continually, it could not be said that anything has happened to upset the Plan. Nor yet if cash is used, as it often is, for the purchase of Government bonds. There is no difference, we submit, where cash is used to reduce outstanding claims in such manner that the new company is relieved from a current burden and provided with an additional asset (here the increased equity in the equipment and the full ownership of the Junction Company). The holders of new securities under the Plan are entitled to the cash. They are entitled, indeed, to receive all of it as a distribution of interest and dividends on the new securities. Their rights can surely be no less because of a choice by the operating management to apply the cash for the benefit of the road, whether in property improvements or in reductions of debt."

Consummation of the Plan in such circumstances will give the benefit of this value, in whatever form at the moment represented, to those entitled under the Commission's Plan, and in the same proportions. The Circuit Court shifts those proportions, by increasing the share of a junior interest, because of the mere chance of the particular use, among many conceivable uses, to which cash on hand after the stated effective date is put. Such slavery to form was rejected in the Southern District of Illinois in the important Rock Island reorganization upon paying off the large debt to RFC involved in that case:

> "Clearly the payment of a claim or the purchase of securities would not afford a basis for a redistribution of securities allotted under the plan. It would amount merely to appropriating surplus earned since the effec-

tive date of the plan to one of the several uses to which it could be applied. All those who have interests, as stockholders of the reorganized company in the earned surplus would benefit from such a use of the money consistently with the plan, just as they would if the money were spent for additions and betterments or used after the consummation of the plan to purchase securities. If there were a redistribution of the securities that would not be true." (*In re Chicago, Rock Island and Pacific R.*, —— F. S. —— (N. D. Ill. 1945), C. C. H. Bankr. L. S., ¶55,369)

The Circuit Court, therefore, had no justification for overriding the Commission's determinations of public interest and private right. On both grounds its order should be reversed so that, in this respect also, the orders establishing the Plan may be affirmed.

IV
UTAH FUEL STOCK

(a) Introduction

This is a harrower issue. It is whether a system bondholder (of the Western Consolidated Bonds) who has also a first lien on property (namely stock in Utah Fuel Company) owned by others than the Debtor may receive new securities in respect of his total claim and thereafter proceed against the collateral for any deficiency (as the Plan permits[25]), or whether he must first reduce his claim by some amount for the collateral and then receive new securities only for the balance (as the Circuit Court requires).

[25] R. 20-21, 136, 167. Clearly, however, the Plan does not mean that they may receive, in the aggregate, more than the amount of their claim.

(b) THE FACTS.

Utah Fuel Company is a New Jersey corporation with a capitalization of 100,000 shares of stock (R. 1114, Ex. 253). It was organized in 1900 and acquired various coal properties in Utah in territory served by the Rio Grande (*id.*). Production was originally at a substantial figure, but declined from an average of nearly 2,000,000 tons a year in 1913-21 to less than half that figure in the 'thirties (*id.*, p. 23), reflecting a sharp increase in competition (*id.*, p. 25)[26]. During the eight-year period 1922-1929, earnings, though fluctuating sharply, averaged $317,000 a year after depreciation (*id.*, p. 95). During the seven-year period 1930-36, average earnings were a deficit of $10,000 a year (*id.*, p. 97).[26] A total going concern value at the 1936 year-end of $4,650,000 was estimated (*id.*, p. 33). There is no testimony supporting a higher value, and there is no testimony at all that any such price could be realized in the market. No dividends have been paid since the 1924 reorganization of the Debtor except $250,000 paid in 1934, which was paid, despite a failure to earn any net income for six years, out of depletion cash, at a time when the Debtor was struggling to avoid bankruptcy; one-third of that amount was, in the opinion of the Debtor's witness, adequate recognition of annual earning power:[27]

> "In determining a proper allowance to make the RGW Consol's for this stock, neither the earnings of the company in the past, nor the book value of its property at the moment, furnish a suitable base." (R. 1102)

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[26] In the extraordinary conditions of war time, earnings have been much higher: $415,000 for 1942 and $536,000 for the first seven months of 1943 (R. 1052).

[27] R. 1102, 713.

The Western Consolidated Mortgage is an indenture executed by The Rio Grande Western Railway Company under date of April 1, 1899, to secure an issue of its First Consolidated Bonds (R. 1079, Ex. 34, D. Ct. Pro. 806). Utah Fuel Company was not in existence at that time. The mortgage, however, provided that among the additional bonds that might be issued thereunder were bonds in an amount not exceeding 10 million dollars which might be issued from time to time "to pay for acquisitions lawfully made with a view of increasing its traffic or earnings" (R. 1079-80).

By an agreement of May 23, 1901 (R. 1080, Ex. 34j), between Spencer Trask & Company, the Rio Grande Western and the Indenture Trustee, the first of these parties, reciting that it then owned all the Utah Fuel stock, pledged it with the Indenture Trustee "in all respects subject to the terms and conditions of said mortgage" (but with a right of redemption upon depositing with the Indenture Trustee 6 millions in cash or in Western Consols) and assigned the equity of redemption to the Rio Grande Western. Against this pledge 6 million dollars principal amount of Western Consols were issued,[28] for the evident purpose of providing payment for the stock.

In 1908 the Rio Grande Western was consolidated with The Denver and Rio Grande Railroad Company (1886) to form a new corporation under the latter name. Upon default of certain Western Pacific bonds guaranteed by the 1886 company, a deficiency judgment for an amount ultimately exceeding 40 million dollars was obtained against the consolidated company.[29] Its properties were sold in execution

[28] *Denver and Rio Grande Railroad Company*, 26 Val. Rep. 733, 888 (1929).

[29] See *Equitable Trust Company* v. *Western Pacific Ry.*, 244 F. 485 (S.D.N.Y. 1917) and *Equitable Trust Company* v. *Denver and Rio Grande R.*, 250 F. 327 (C.C.A. 2, 1918).

of that judgment on November 20, 1920.[30] The purchasers conveyed the railroad properties to the Debtor,[31] and all its stock was issued to The Western Pacific Railroad Corporation. The Utah Fuel stock, however, was transferred by the purchasers, subject to the lien of the Western Consolidated mortgage, to The Western Pacific Railroad Corporation (R. 1082, Ex. 35). The Debtor never acquired title.

The Debtor could not sustain the burden of the debt left on it in that reorganization. Receivers were appointed in 1922 and a further reorganization (R. 1083) was consummated in 1924.[32] As a part of that plan the Missouri Pacific acquired half of the Western Pacific holdings, not only in stock of the Debtor but also in the Utah Fuel stock. As an inducement to bondholders not to disturb the old stock of the Debtor, they put up their interest in the Utah Fuel stock as additional security under the two new mortgages created in that reorganization. This was done by an agreement of December 20, 1924 (R. 1081, Ex. 35). The two new mortgages were the R&I Mortgage, to provide for new financing, and the General Mortgage, to provide for some of the old debt. The words were that the Missouri Pacific and the Western Pacific, while reserving to themselves "the ultimate beneficial interest in said 100,000 shares of the capital stock of Utah Fuel Company" (*id.*, R. 1084), assigned their interest to a trustee so that dividends on it should be paid to the Debtor so long as any bonds issued under the new mortgages (or any other bonds issued to refund them)

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[30] See *Equitable Trust Co.* v. *Denver and Rio Grande R.*, 269 F. 987 (D. Col. 1920); *Levy* v. *Equitable Trust Co.*, 271 F. 49 (C.C.A. 8, 1921); *Beer's* v. *Equitable Trust Co.*, 286 F. 878 (C.C.A. 8, 1923) and *Beers* v. *Denver and Rio Grande R.*, 286 F. 886 (C.C.A. 8, 1923).

[31] See *Stock of Denver and Rio Grande Western Railroad*, 70 I.C.C. 102 (1921).

[32] See *Denver and Rio Grande Western Reorganization*, 82 I.C.C. 745 (1923) and 90 I.C.C. 141 (1924) and *Denver and Rio Grande Investigation*, 113 I.C.C. 75 (1926).

should be outstanding, unless the Debtor's net income should exceed stated limits (*id.*, R. 1084-85). It was further provided that upon foreclosure of the mortgage securing any such bonds, the assignors' interest in the Utah Fuel stock should, subject to the lien of the Western Consolidated Bonds, be sold, and the proceeds be applied to the payment of such bonds, any surplus to be divided equally between the Missouri Pacific and the Western Pacific (*id.*, R. 1089-90).

While the Debtor joined in this agreement as a formal transferor in order to avoid any question of title arising from the reorganization, it is perfectly clear that the Debtor did not then have, and did not thereby acquire, any interest in the Utah Fuel stock. As the Commission, in authorizing the consummation of the Plan, declared:

> "... the applicant [the Debtor] neither owns, nor under the plan of reorganization is to acquire ownership of, the stock of the Utah Fuel Company ..." (*Denver and Rio Grande Western Reorganization*, 90 J. C. C. 141, 148 (1924))

The transaction was only that the equity of redemption in the Utah Fuel stock was put up by its owners as additional security for the new bonds created in reorganization, as part of the consideration to creditors for not disturbing the equity. This subjection of the stock by its pledgors to the liens of additional mortgages of the Debtor was not intended to transfer the equity of redemption from the pledgors to the Debtor.* On the contrary, in the operative words of the parties themselves, "the ultimate beneficial interest" remained with the Western Pacific and the Missouri Pacific.

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* The Debtor has never recorded the Utah Fuel stock on its books but has uniformly recorded the 1924 contract at $1 (Ex. 25-B (I Tr. 2839) and I.C.C. Tr. 137-8 (I Tr. 2064-65); "Income Account and Financial Exhibit" for December 31, 1944, p. 7.)

(c) The Law

Since the Utah Fuel stock is not property of the Debtor, it is not subject to disposition under Section 77, for that deals only with the "debtor and *its* property".[34] The Commission therefore properly left the Utah Fuel stock subject to pledge under the Western Consolidated Mortgage.

In doing so, the Commission followed the controlling precedent of this Court's decision in the *Western Pacific Case*. There the Commission held that the plan should be framed as

> "in no wise disturbs or alters the rights of the Reconstruction Finance Corporation and the Railroad Credit Corporation in collateral pledged with them by parties other than the debtor." (*Western Pacific Railroad Company Reorganization*, 230 I. C. C. 61, 102 (1938), and to the same effect at 233 I. C. C. 409, 432 (1939)).

Accordingly its plan (233 I. C. C. at 453) left the collateral undisturbed. As this Court said:

> "This collateral . . . was therefore left with the pledgees with its position unaffected by any direct action of the Commission." (*Western Pacific Case*, 318 U. S. at 506 (1943))

Under the decision The Railroad Credit Corporation received new securities in respect of the full amount of Western Pacific bonds pledged with it, without any reduction because of estimated realization from the collateral pledged with it by others, and retained its full rights in such other collateral. Later the District Court in charge of the properties permitted The Railroad Credit Corporation to receive the payments made to it on such other collateral, over the objection of the Debtor that the award of new securities to it in the plan had made it whole, because:

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[34] Section 77(a), italics added.

". . . the market value of the [new] securities is much less than their face value . . . and it will not be able to realize thereon enough to satisfy its claim. . . ."

In the case at bar the Commission scrupulously followed the Western Pacific precedent, for extra caution spelling out the powers of the pledgee rather than merely leaving them implicit as in the *Western Pacific Case*. In result, the Western Consolidated bondholders remained free to realize on the Utah Fuel stock by future proceedings. But of course the Western Consolidated bondholders may not obtain a total realization, measured by actual value, that exceeds the amount of their claim.[36] So when enforcement of the pledge by distribution or sale is sought, and the Western ConsolidatedTrustee acknowledges that it can be sought only through judicial proceedings, it will be appropriate in those proceedings to inquire whether such action will result in any excess realization. Full protection can then be given to all those who have any junior interest in the stock. Though it may be thought obvious that no such overpayment could in fact result,[37] that question has not arisen, for the Indenture Trustee has not yet taken any move to accomplish the distribution or sale of the stock. Until then, there is no question to consider.

But the fact that future realization on the collateral of others will be limited by the actual value received from the

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[35] *In the Matter of The Western Pacific Railroad Company*, N. D. Cal. S. D., No. 26,591-5, June 21, 1944 (unreported), *aff. sub nom The Railroad Credit Corporation* v. *Ecker*, —— F. 2d —— (Dec. 7, 1945, C.C.A. 9). That is the case here, for, as shown in Appendix G, the Western Consolidated bondholders receive, on the basis of when issued quotations, only about two-thirds of their total claim.

[36] *Merrill* v. *National Bank of Jacksonville*, 173 U. S. 131 (1899).

[37] The Plan takes from the Western Consols the high leverage of their position on the western half of the system, junior only to the First Trust 4's (as a result of which the earnings applicable to them per bond increase sharply once the Trust's are covered) and gives them in return only 20% in Income Bonds, 73% in Preferred Stock and 7% in Common (R. 182).

estate does not mean that the realization from the estate is to be limited by what may later be received on such collateral. Just the contrary was held in the *Western Pacific Case*. The decision in that respect applied the unbroken rule that in such cases the collateral creditor need not deduct the value of his collateral in distributions from the estate (which allocations of new securities are) but may receive recognition out of the estate on the basis of the total amount of his claim and thereafter realize upon his collateral up to an aggregate actual value equalling the amount of his claim.

This was the settled rule in equity reorganizations (*Merrill* v. *National Bank of Jacksonville*, 173 U. S. 131 (1899)), the basic principle being that

> ". . . no part of his security can be taken from a secured creditor until he is completely satisfied." (138)

In bankruptcy proceedings a different rule was laid down with respect to collateral owned by the bankrupt, but only for property so owned. Thus Section 1(28), 11 U. S. C. Sec. 1(28), defines "secured creditor" as including

> ". . . a creditor who has security for his debt *upon the property of the bankrupt* . . . or who owns such a debt for which some endorser, surety, or other person secondarily liable for the bankrupt has such security upon the bankrupt's assets;" [italics added.]

Dealing with this defined term, Section 57(h), 11 U. S. C. Sec. 93(h), provides:

> "The value of securities held by secured creditors shall be determined by converting the same into money according to the terms of the agreement pursuant to which such securities were delivered to such creditors, or by such creditors and the trustee by agreement, arbitration, compromise or litigation, as the court may direct, and the amount of such value shall be credited

upon such claims, and a dividend shall be paid only on the unpaid balance. Such determination shall be under the supervision and control of the court."

Though the procedure specified in this Section for a determination of value is clearly inapplicable in railroad reorganizations, the Commission being designated for that purpose,[36] it has been held that the remainder of this Section, that is, the requirement that the value of the collateral shall be credited upon the claim before determining distributions from the estate, applies under Sec. 77 (*New York Trust Co.* v. *Palmer*, 101 F. 2d 1, 3 (C.C.A. 2, 1939)).

But it is clear, by the very words of the Act, that this requirement applies only to "security . . . upon the property of the bankrupt." It is always recognized that no deduction is required for the value of collateral which is not "the property of the bankrupt," but is the property of some one else, for in that situation the rule in equity proceedings, being unchanged by the statute, prevails in full force.[37] The rule is well shown by the following quotation:

"Unless the petitioner was a secured creditor as defined by §1 (23) [presently §1 (28)] it was not bound

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[36] The last paragraph of Sec. 77(e) provides that:

"If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan."

[37] Illustrative citations are:

Ivanhoe Building & Loan Association v. *Orr*, 295 U. S. 243, 245 (1935);

Swarts v. *Fourth National Bank*, 117 F. 1, 12 (C.C.A. 8, 1902);

Gorman v. *Wright*, 136 F. 164, 165 (C.C.A. 4, 1905);

Board of County Comr's. v. *Hurley*, 169 F. 92, 95, 97 (C.C.A. 8, 1909);

In Re New York Commercial Co., 233 F. 906, 909 (C.C.A. 2, 1916);

In Re United Cigar Stores Co., 73 F. 2d 296, 298 (C.C.A. 2, 1934), *cert. den.* 294 U. S. 708 (1935);

(*continued on next page*)

to have its security or the avails thereof valued and to prove only for the difference between that value and the face amount of the debt. Petitioner does not come within the definition, for at the date of bankruptcy it held no security against the bankrupt company's property, nor security given by any other person who in turn was secured by the bankrupt's assets. Sections 1(23) and 57(e) [11 U. S. C. §93 (h)] do not, therefore, forbid the proof of a claim for the principal of the bond with interest, though the petitioner may not collect and retain dividends which with the sum realized from the foreclosure will more than make up that amount." *(Ivanhoe Building & Loan Association* v. *Orr*, 295 U. S. 243, 245-6 (1935)).

As collateral in which the equity of redemption belongs to others does not become "property of the bankrupt" because pledged for one obligation of the bankrupt, so it does not when pledged for two or more obligations of the bankrupt. As this is true in the former case without regard to relative values, so it is also in the latter case. None of these factors has any relation to the policies of the rule. A policy of the rule is that creditors of the bankrupt who have a lien on property of others shall be entitled to full recovery on their total claim against the bankrupt without being forced to give other creditors a virtual participation in their security. The Western Consolidated bondholders are entitled to assert that statutory right whether they have the only lien, or whether junior lienors exist, and whether they will, upon foreclosure, be entitled to the whole of such collateral or will leave behind some surplus to be divided among junior claimants according to the same rules and subject to the same limitations. Those questions pertain only to the

In Re Fay Stocking Co., 95 F. 2d 961, 962 (C.C.A. 6, 1938);
In Re Headley, 97 F. 765, 771 (W.D. Mo. 1899);
In Re Blizard, 20 F. S. 481, 482 (E. D. Penn. 1937);
In Re Guilliot, 37 F. S. 929, 931 (W. D. La. 1942).

methods to be followed when foreclosure upon the outside collateral shall hereafter be attempted, and do not, as the General Mortgage Trustee erroneously argues,[40] have any bearing on the distribution to be made from the estate by allocations of new securities in the Plan. All those questions may be faced at the time of subsequent foreclosure upon the collateral in the judicial proceedings to be taken for that purpose.

Manifestly, therefore, it was proper, and indeed necessary, for the Commission to allot new securities to the Western Consolidated Bonds in respect of their total claim without any deduction because of the Utah Fuel stock while at the same time permitting later enforcement of all rights under the instruments of pledge.

Some suggestion is made here by the Debtor that the parties have agreed on the reverse of the above procedure.[41] But this suggestion is erroneous. The indenture supplemental to the Western Consolidated Mortgage, executed at the time of the pledge in 1901 (R. 1080), contains no provision remotely relating to this subject, nor does any other supplemental indenture to that mortgage. The agreement cited by the Debtor is the agreement of 1924 by which the Western Pacific and the Missouri Pacific subjected their equity of redemption in the Utah Fuel stock to certain terms of the R&I and the General Mortgage that were being concurrently executed. As shown above (p. 93), those rights included the privilege on the part of the indenture trustee under each of those two mortgages, in that order of priority, or under any mortgage executed to secure bonds for the purpose of refunding the bonds secured by them, to realize on the equity of redemption in the Utah Fuel stock, subject to its prior pledge under the Western Consolidated Mort-

[40] Brief in opposition to certiorari, pp. 17-18.

[41] Debtor's brief in opposition to certiorari, p. 7.

gage. In that connection the 1924 agreement (R. 1090) empowered such indenture trustees, or a preferred stockholders' committee therein named, to require realization under such mortgages upon the equity of redemption in the Utah Fuel stock before foreclosure sale of the railroad. But this has nothing whatever to do, and could not possibly have, with the vested rights of the Western Consolidated bondholders for the enforcement of their mortgage.

There is, accordingly, no contractual reversal of the ordinary rule, the cited provision of the Plan is proper and the action of the Circuit Court should in this respect also be reversed so that the orders establishing the Plan may be affirmed.

V

THE POWER TO CONFIRM OVER A DISSENT

(a) The Question

As a result of the 1935 amendment, Section 77(e) provides that upon approval of a plan by the District Court, it shall be submitted to all affected classes of security holders, except those whose interests are not of value, for their acceptance or rejection. If more than two-thirds in amount of those voting in each such class accept the plan, the judge shall confirm it if satisfied as to the legality of the voting, without re-examination of the merits of the plan.[42] The Act then proceeds:

> ". . . if the plan has not been so accepted . . . the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing [*i*] that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; [*ii*] that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and

[42] Next to last paragraph of Section 77(e).

all the relevant facts; and [*iii*] that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e):"[a]

Upon submission of the Plan in this case, it was accepted by the statutory percentages of all such classes except the General Mortgage Bonds. They rejected the Plan. This dissent represented 4.1% of all affected secured indebtedness, or 8.3% of all claims actually voted (R. 267). It represented 17.1% of the outstanding General Mortgage bonds, though, since only 21.5% of them were voted, it was 79.3% of those voted.

After the hearing, the District Court made the statutory findings and confirmed the Plan over this dissent (R. 224).

On appeal to the Circuit Court, the General Mortgage Trustee urged that (*a*) the Act, properly interpreted, does not purport to authorize confirmation over such a dissent (particularly a dissent by a majority of those voting) and (*b*) if so interpreted, the Act is unconstitutional.

The Circuit Court, at the conclusion of its opinion, held:

> "It follows from what has been said that the General Bondholders were reasonably justified, within the meaning of the statute, in rejecting the plan, and that the District Court was without authority to confirm the plan in the face of their adverse vote." (R. 253)

This is the first holding that a dissenting class has a right of veto. The holding is obscure, for its grounds, and the resulting limits of its applicability, are not stated.

If it were true, which we submit it is not, that the Plan fails to satisfy the fair and equitable requirements of the Act, then, on that ground, it would follow that the District

[a] Next to the last paragraph of Section 77(e). Roman numbering interpolated.

Court, being obliged, in the event of a dissent, to find again that those requirements of the Act have been satisfied, may not confirm the Plan. But it is important, we believe, that this be established as the only test. If the Plan is fair and equitable (as the preceding discussion submits and as for present purposes we take it to be), no one can have a right of veto as a means of bargaining for preferential treatment. That is true, we submit, as a matter both of statutory construction and of constitutionality.

(b) Statutory Construction

The main purpose of the 1935 amendment, as we pointed out at page 37 above, was to eliminate the practical right of veto that was considered to vest in security holders under the original Act. Of the two means chosen for this purpose, the simplified test of value for reorganization purposes and the power to confirm over a dissent, the former was discussed there. The latter is decisive here. Of the two, the power to confirm over a dissent is the more critical, for it is the key to the whole Congressional plan for workable legislation. Thus the proposal was recommended to the House Judiciary Committee by Joseph B. Eastman, then Federal Coordinator of Transportation and proponent of the amendments, with this explanation:

> "Perhaps the most serious defect is that it was not realized when the act was passed to what extent it put it in the power of nonassenting classes of security holders to prevent a reorganization."[44]

It was just for the purpose of eliminating that veto power that the quoted provision was proposed and enacted. As Leslie Craven, counsel for Mr. Eastman and draftsman of the bill, explained to the House Committee:

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[44]Hearings before the Committee on the Judiciary on H. R. 6249, 74 Cong., 1st Sess. (1935) p. 15.

". . . the effect of those provisions is this, that if a plan is not approved by the requisite two-thirds of a class, the judge may nevertheless confirm the plan if he finds, after hearing, that it conforms to those requirements . . .

"In other words, in those cases where it is not possible to get the necessary percentage of assents, the court under these defined conditions can require that they take such provision as the plan provides for them . . ."[45]

The substantive principles incorporated in the Act are the numbered clauses in the quotation on pp. 100-1 above. Clause [*i*] requires only that the plan make "fair and equitable" provision for dissenters. Its obvious purpose was to outlaw the old equity practice of providing less for dissenters than for assentors. No question arises under it here. Clause [*iii*] lays down the basic requirement that the plan itself be "fair and equitable." For the purposes of the present question we assume this to be satisfied, as we have submitted above that it in fact is, and no question under it is pertinent here. Clause [*ii*] requires that the dissent be "not reasonably justified." The meaning of that language is the only question presented here.

Of course one should read "text in the light of context".[46] These words are colored by their setting in the Act, and alike by its policies. They preclude any interpretation that would revive the old veto power which it was a leading purpose of the Congress to extirpate. But it would be effectively revived by any interpretation that would permit a class of security holders to reject, and thus block, a plan unless they received something more than "fair and equitable" treatment, whether the improved treatment is characterized as superior to the "fair and equitable" provision or merely as lying at so high a level within the permissible area of Commission

[45] *Id.*, p. 339.

[46] *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.*, 320 U. S. 344, 351 (1943).

judgment of what constitutes "fair and equitable" provision that no reasonable person could reject it. In the first alternative, all action is paralyzed, for no plan could lawfully award any class more than what is "fair and equitable", yet each class could veto it unless it did. In the second alternative, which seems to be the contention of the General Mortgage Trustee, the court would have to accord to the judgment of security holders as expressed in their vote somewhat the same effect as to the findings of an administrative agency, and thus be compelled, by equal and opposite forces, to reject the plan and to confirm it. Either interpretation nullifies the Act. Under either one, each class would be entitled to jockey with the Commission for a better track and the administrative findings to which the Congress looked in such large measure for the settlement of reorganization problems would merely signal to the post for that unseemly spectacle. It is contrary to the policies of the Act to encourage dissents by the stimulating expectation that a dissent will procure anything better than "fair and equitable" treatment.[47]

So clause [*ii*] can not, consistently with the policies of the Act, contemplate any standard other than that of a fair and equitable plan. Its effect is that the District Court, when required by a dissent to reconsider the merits of a plan, shall do so "in the light of the respective rights and interests of those rejecting it and all the relevant facts." For one thing this means that the District Court, while still judging the plan as of the "time of the finding" by the Commission, shall do so in the light of later events to the time of confirmation.[48] For the rest, it is surely relevant to observe that the General Mortgage Bondholders are the most junior lien and get everything left after giving the Senior Claims only an equal

[47]Thus see *Mason* v. *Paradise Irrigation District*, —— U. S. —— (1946).

[48]See also the discussion of this point beginning at p. 37 above.

face amount of new securities, though it has not been found and can not be assured, that such treatment will approximate payment of all the Senior Claims.

Respondents are misled by the mere mechanics of the voting into rigid concepts that defeat the Congressional purpose. The voting is not, as they urge, a useless gesture unless it operates to give some power to veto. On the contrary, it requires a reexamination of the merits of the plan by the court and throws a spotlight on the situation of any particular class that may dissent, thus aiding the court to focus on the pertinent questions. This was clearly put to the Judiciary Committee by Mr. Eastman himself, in words we think decisive here, not only as an episode of legislative history, but also as a formulation of the applicable policies:

> "Nothing can be forced upon them without an adjudication of their rights in accordance with sound principles which are definitely stated in the bill, and by two tribunals, the Commission and the court; and before any such adjudication is made, they are given opportunity not only to argue their rights and to submit what evidence they may desire to submit at public hearings, but to vote upon any plan before it is made effective, in order that the court may be fully informed in regard to the position of each and every class of security holders, whether they be debtors or creditors."[49]

Of course the Act draws no distinction, in this power to confirm over a dissent, according to the percentages of the vote, whether the dissent is a minority of the vote, or a majority of the vote or the whole of the vote, but confers the power equally in all situations of the vote. Nor can the fair and equitable standard of the Act be varied by the fact, much urged below by the General Mortgage Trustee, that there has been pending for some time before the Congress a pro-

[49] Hearings before Committee on the Judiciary on H. R. 6249, 74th Cong., 1st Sess. (1935) 282.

posal, known as the Hobbs Bill, to change the Act, for that proposal has not been adopted.[50]

(c) Constitutionality

The argument of the General Mortgage Trustee on the constitutional point is that, upon a dissent by a majority of the voted General Mortgage bonds, those bondholders are constitutionally entitled to obstruct the will of the Congress and the concurring judgment of the Commission and the District Court that the plan is fair and equitable, in order, so it would seem, that the General Mortgage bondholders may suffer the fate plainly awaiting them in equity practice of being sold out in foreclosure of senior liens.

In properties of this size a foreclosure sale has uniformly been recognized as a mere device to accomplish predetermined reorganization aims.[51] It is not realistic to suppose that the most junior lienor can derive any substantive advantage from that technique. Nor is there now any arguable constitutional question about the power of the Congress to substitute improved remedial methods.

This question was presented to this Court on application for certiorari to the Seventh Circuit to review the affirmance of a decree confirming a plan over the dissent of 49.63% of those voting in one class[52] and certiorari was denied. Clearly the Court did not consider that any substantial constitutional question was presented and its action is generally

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[50] Adopted by the House on a favorable report from the Committee on the Judiciary (H. R. Rep. No. 1615, 78th Cong., 2d Sess. (1944)), but still pending in Committee in the Senate.

[51] *Canada Southern R.* v. *Gebhard*, 109 U. S. 527, 539 (1883); Paul D. Cravath, "The Reorganization of Corporations", "Some Legal Phases of Corporate Financing, Reorganization and Regulation", p. 153 at 204-5 (1916).

[52] *In re Chicago and North Western R.*, 126 F. 2d 351 (C.C.A. 7, 1942), *cert. den.* 318 U. S. 793 (1943).

thought of as ending all constitutional doubt.[53] The Circuit Court of Appeals had quoted with approval the following statement of the District Court:

> ". . . the power to confirm a composition over the objection of 33 1/3% of the creditors is exactly the same kind of a power as the power to confirm a composition over the objection of 49.63%, or for that matter over the objection of 100% of them. It is a bankruptcy power."[54]

Since then the District Court for the Eastern District of Missouri has ruled similarly, in a case where the plan was rejected by a majority of the voted claims in six classes:

> "We can conceive of a situation where one or more classes of creditors would vote against a plan even though it had met all legal requirements including those of fairness and equity. According to the contention here made, the Court cannot override the creditors veto and the reorganization process might be continued indefinitely and perhaps forever. This is not to be countenanced. Against the public interest, even a large group of creditors may be considered to be but a dissident and obstructive minority." (*In re Missouri Pacific R.*, 50 F. S. 936, 943 (E. D. Mo. 1943)).[55]

This is in accord with sound principle. A mortgagee is constitutionally entitled to some substantial access to the benefit of his security,[56] but not by any particular procedural methods, for they may be revised as the Congress

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[53] *E.g.*, Robert T. Swaine, *A Decade of Railroad Reorganizations under Section 77 of the Bankruptcy Act* (1943) 56 Harv. L. Rev. 1037, 1053.

[54] *Id.*, at 126 F. 2d 365, n. 9.

[55] Similar views had been declared also in *In re New York, New Haven & Hartford R.*, 16 F. S. 504, 509-12 (D. Conn. 1936).

[56] *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555 (1935).

thinks appropriate in the public interest.[57] Thus the Congress may abolish the right of foreclosure where the mortgagee is paid the value of the property as found by the court:

> "Safeguards were provided to protect the rights of secured creditors, throughout the proceedings to the extent of the value of the property . . . There is no constitutional claim of the creditor to more than that." (*Wright* v. *Union Central Life Insurance Co.*, 311 U. S. 273, 278 (1940); *rehearing den.*, 312 U. S. 711 (1941)).

If an award of cash found to be the value of the lien position satisfies all constitutional rights in the case of an average-sized loan to an individual, an award of new securities found to be the equitable equivalent of the existing position must do so in the case of a large interstate railroad, where outside purchasers are unobtainable and new securities are the customary medium of satisfaction.[58] Opposition by all members of the affected class must, therefore, be as constitutionally meaningless in the latter case as in the former. No other conclusion would accord with the public interest in railroad reorganizations[59] or with the "radically progressive nature" of the bankruptcy power.[60] Nor would any

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[57] *Wright* v. *Vinton Branch*, 300 U. S. 440 (1937), limiting the case cited in the next preceding footnote.

[58] So held even in the absence of enabling legislation in *Phipps* v. *Chicago, Rock Island & Pacific R.*, 284 F. 945 (C.C.A. 8, 1922).

[59] Craven and Fuller, *The 1935 Amendment of the Railroad Bankruptcy Law* (1936) 49 Harv. L. Rev. 1254, 1279-81.

[60] *Continental Illinois National Bank* v. *Chicago, Rock Island & Pacific R.*, 294 U. S. 648, 671 (1935). And see *Gilfillan* v. *Union Canal Co.*, 109 U. S. 401, 404 (1883), holding that a statute may constitutionally presume the assent of security holders who do not vote; under such a presumption, a majority of the General Mortgage bondholders have accepted the Plan. Due process "demands only that the law shall not be unreasonable, arbitrary or capricious, and that the means selected shall have a real and substantial relation to the object sought to be attained." (*Nebbia* v. *New York*, 291 U. S. 502, 525 (1934).

other conclusion accord with the settled rule that by such proceedings a creditor may be denied all recognition (*Western Pacific Case*, 318 U. S. at 476), for the power to deny includes the power to limit.

We submit, therefore, that there is no constitutional obstacle to full effectuation of the Congressional will that a court, reconsidering a plan in the light of a dissent and again finding it fair and equitable, may confirm the plan and the dissenters have no right of veto.

CONCLUSION

The Circuit Court, we submit, errs in each of the particulars in which it requires a change in the Commission's Plan. Its order, therefore, should be reversed in its entirety, with instructions to affirm the orders of the District Court approving and confirming the Plan, so that this reorganization, already so long considered by the Commission and the courts, may move forward to its completion in accordance

with the Congressional policy of prompt action in these matters colored by the public interest.

Dated February 2, 1946.

Respectfully submitted,

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APPENDIX B

Excerpts from Section 77 of the Bankruptcy Act As Amended.

(a) . . . If the petition is so approved, the court in which such order is entered shall, during the pendency of the proceedings under this section and for the purposes thereof, have exclusive jurisdiction of the debtor and its property wherever located, and shall have and may exercise in addition to the powers conferred by this section all the powers, not inconsistent with this section, which a Federal court would have had if it had appointed a receiver in equity of the property of the debtor for any purpose . . .

. . . . . .

(e) Upon the certification of a plan by the Commission to the court, the court shall give due notice to all parties in interest of the time within which such parties may file with the court their objections to such plan, and such parties shall file, within such time as may be fixed in said notice, detailed and specific objections in writing to the plan and their claims for equitable treatment. The judge shall, after notice in such manner as he may determine to the debtor, its trustee or trustees, stockholders, creditors, and the Commission, hear all parties in interest in support of, and in opposition to, such objections to the plan and such claims for equitable treatment. After such hearing and without any hearing if no objections are filed, the judge shall approve the plan if satisfied that: (1) It complies with the provisions of subsection (b) of this section, is fair and equitable, affords due recognition to the rights of each class of creditors and stockholders, does not discriminate unfairly in favor of any class of creditors or stockholders, and will conform to the requfrements of the law of the land regarding the participation of the various classes of creditors and stockholders; (2) the

approximate amounts to be paid by the debtor, or by any corporation or corporations acquiring the debtor's assets, for expenses and fees incident to the reorganization, have been fully disclosed so far as they can be ascertained at the date of such hearing, are reasonable, are within such maximum limits as are fixed by the Commission, and are within such maximum limits to be subject to the approval of the judge; (3) the plan provides for the payment of all costs of administration and all other allowances made or to be made by the judge, except that allowances provided for in subsection (c), paragraph (12) of this section, may be paid in securities provided for in the plan if those entitled thereto will accept such payment, and the judge is hereby given power to approve the same.

If the judge shall not approve the plan, he shall file an opinion, stating his conclusions and the reason therefor, and he shall enter an order in which he may either dismiss the proceedings, or in his discretion and on motion of any party in interest refer the proceedings back to the Commission for further action, in which event he shall transmit to the Commission a copy of any evidence received. If the proceedings are referred back to the Commission, it shall proceed to a reconsideration of the proceedings under the provisions of subsection (d) hereof. If the judge shall approve the plan, he shall file an opinion, stating his conclusions and the reasons therefor, and enter an order to that effect, and shall send a certified copy of such opinion and order to the Commission. The plan shall then be submitted by the Commission to the creditors of each class whose claims have been filed and allowed in accordance with the requirements of subsection (c) hereof, and to the stockholders of each class, and/or to the committees or other representatives thereof, for acceptance or rejection, within such time as the Commission shall specify, together with the report or re-

ports of the Commission thereon or such a summarization thereof as the Commission may approve, and the opinion and order of the judge: *Provided*, That submission to any class of stockholders shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, (a) that at the time of the finding the corporation is insolvent, or that at the time of the finding the equity of such class of stockholders has no value, or that the plan provides for the payment in cash to such class of stockholders of an amount not less than the value of their equity, if any, or (b) that the interests of such class of stockholders will not be adversely and materially affected by the plan, or (c) that the debtor has pursuant to authorized corporate action accepted the plan and its stockholders are bound by such acceptance: *Provided further*, That submission to any class of creditors shall not be necessary if the Commission shall have found, and the judge shall have affirmed the finding, that the interests of such class of creditors will not be adversely and materially affected by the plan, or that at the time of the finding the interests of such class of creditors have no value, or that the plan provides for the payment in cash to such class of creditors of an amount not less than the value of their interests. For the purpose of this section the acceptance or rejection by any creditor or stockholder shall be in writing, executed by him or by his duly authorized attorney, committee, or representative. If the United States of America, or any agency thereof, or any corporation (other than the Reconstruction Finance Corporation) the majority of the stock of which is owned by the United States of America, is a creditor or stockholder, the interests or claims thereof shall be deemed to be affected by the plan, and the President of the United States or any officer or agency he may designate, is hereby authorized to act in respect of the interests or claims of the United States or of such agency

or other corporation. The expense of such submission shall be certified by the Commission and shall be borne by the debtor's estate. The Commission shall certify to the judge the results of such submission.

Upon receipt of such certification, the judge shall confirm the plan if satisfied that it has been accepted by or on behalf of creditors of each class to which submission is required under this subsection holding more than two-thirds in amount of the total of the allowed claims of such class which have been reported in said submission as voting on said plan, and by or on behalf of stockholders of each class to which submission is required under this subsection holding more than two-thirds of the stock of such class which has been reported in said submission as voting on said plan; and that such acceptances have not been made or procured by any means forbidden by law: *Provided*, That if the plan has not been so accepted by the creditors and stockholders, the judge may nevertheless confirm the plan if he is satisfied and finds, after hearing, that it makes adequate provision for fair and equitable treatment for the interests or claims of those rejecting it; that such rejection is not reasonably justified in the light of the respective rights and interests of those rejecting it and all the relevant facts; and that the plan conforms to the requirements of clauses (1) to (3), inclusive, of the first paragraph of this subsection (e): *Provided further*, That if, in any reorganization proceeding under this section, the United States is a creditor on claims for taxes or customs duties (whether or not the United States has any other interest in, or claim against, the debtor, as creditor or stockholder), no plan which does not provide for the payment thereof shall be confirmed by the judge except upon the acceptance certified to the court, of a lesser amount by the President of the United States or the officer or agency designated by him pursuant to the provisions of

the preceding paragraph hereof: *Provided further*, That if the President of the United States or such officer or agency shall fail to accept or reject such lesser amount for more than ninety days after receipt of written notice so to do from the court, accompanied by a certified copy of the plan, the consent of the United States insofar as its claims for taxes or customs duties are concerned shall be conclusively presumed. If the judge shall confirm the plan, he shall enter an order and file an opinion with a statement of his conclusions and his reasons therefor. If the judge shall not confirm the plan, he shall file an opinion, with a statement of his conclusions and his reasons therefor, and enter an order in which he shall either dismiss the proceedings, or, in his discretion and on the motion of any party in interest, refer the case back to the Commission for further proceedings, including the consideration of modifications of the plan or the proposal of new plans. In the event of such a reference back to the Commission, the proceedings with respect to any modified or new plan shall be governed by the provisions of this section in like manner as in an original proceeding hereunder.

If it shall be necessary to determine the value of any property for any purpose under this section, the Commission shall determine such value and certify the same to the court in its report on the plan. The value of any property used in railroad operation shall be determined on a basis which will give due consideration to the earning power of the property, past, present, and prospective, and all other relevant facts. In determining such value only such effect shall be given to the present cost of reproduction new and less depreciation and original cost of the property, and the actual investment therein, as may be required under the law of the land, in light of its earning power and all other relevant facts.

APPENDIX C

CAPITALIZATION AS OF JANUARY 1, 1943

Title of Issue	Principal	Interest at Contract Rate to Jan. 1, 1943	Total Claim	
RIO GRANDE				
Equipment Obligations	$ 5,758,000		$ 5,758,000	1
Trusts (R. G. W. First Trust 4's)	15,190,000	$ 4,860,800	20,050,800	
Western Consols (R. G. W. Consols)	15,080,000	4,976,400	20,056,400	
Junctions (R. G. J. 5's)				2
Eastern Consols (D. & R. G. Consols)	40,507,000	14,043,615	54,550,615	3
R&I's (Refunding and Improvement)	14,000,000	5,940,000	19,940,000	4
Generals (General Mortgage)	29,808,000	13,740,155	43,548,155	
R. F. C. Notes	10,691,850	3,208,755	13,900,605	5
Chase Bank Note	1,500,000	658,458	2,158,458	6
R. C. C. Note				7
Total Secured Debt	$132,534,850	$ 47,428,183	$179,963,033	
Unsecured claims	440,000		440,000	8
Total Debt	$132,974,850	$ 47,428,183	$180,403,033	
Preferred Stock ($100 par)			16,433,200	9
Common Stock (no par)			62,457,540	10
Stock Liability for Conversion—Preferred			12,400	
Total Stock			78,903,140	
Grand Total			259,306,173	
SALT LAKE				
First Mortgage Bonds	1,500,000		1,500,000	11
Income Mortgage Bonds	11,000,000		11,000,000	12
Common Stock (no par)			5,317,104	13
Total			17,817,104	
SALT LAKE WESTERN				
R F C Note	3,110,850	1,179,977	4,290,827	14
Common Stock ($100 par)			3,631,000	15
Total			7,921,827	

[Notes to this table appear on the following page.]

NOTES TO APPENDIX C

(1) Subsequently reduced by paying principal maturities of $609,000 a year. Currently being increased by a new issue of $2,610,000.

(2) $2,000,000 principal amount, with accumulated interest of $758,333, were outstanding at January 1, 1943, but were purchased by the Debtor Trustees pursuant to an Order of September 16, 1943 (R. 264), under which such bonds are held subject to further order of the District Court.

(3) In two series, 4% and 4½%; for details see Appendix D.

(4) In two series, 5% and 6%; for details see Appendix D.

(5) This claim is the total of three classes of notes:

(i) Five notes dated March 29, 1932—June 30, 1933 in the aggregate principal amount of $3,950,000 (bearing interest at 6%) to provide funds for interest, taxes, etc., secured by various system bonds and other collateral;

(ii) Various notes dated January 1933—August 1934 in the aggregate principal amount of $3,631,000 (bearing interest at 5%) to provide funds for construction of Dotsero Cut-Off, secured by all capital stock of the Salt Lake Western and by collateral under (*i*); and

(iii) One note dated December 19, 1934 for $3,110,850 (bearing interest at 5%) payable to bearer, issued to the Salt Lake Western to provide funds for purchase of Salt Lake stock and secured by all shares so purchased and by collateral under (*i*) and (*ii*); the funds were obtained by the Salt Lake Western from RFC against its own note of equal amount secured by said Rio Grande note and its collateral.

The collateral so held by RFC is:

ISSUE	PRINCIPAL AMOUNT
Trusts	$ 10,000
Western Consols	1,395,000
Eastern Consol 4's	783,000
R&I 5's	4,385,000
Salt Lake Incomes	1,266,000
Salt Lake Western stock	36,310 shs. (all of issued)
Salt Lake stock	45,889 shs. (91.8% of issued)

In addition RFC holds certain motorway stocks, Goshen Valley stock

and Rio Grande Southern R. bonds (taken up in plan at $250,000), a lien on the $662,000 of Eastern Consol 4's pledged under the R. C. C. Note and a second lien on the $6,096,000 of R&I 5's pledged under the Chase Bank Note, and certain contractual rights.

(6) Secured by $6,096,000 of R&I 5's. Interest computed at 6% after default (R. 141 and 21).

(7) Paid ($261,847.01 and interest) by Debtor Trustees on May 17, 1943, pursuant to an Order of April 15, 1943, under which such collateral was to be held so as to preserve without prejudice all rights of all security holders.

(8) Approximate; see R. 183.

(9) No dividends ever paid; 113½% accumulated dividends as of January 1, 1943.

(10) 300,000 shares of no par value, shown at amount stated on balance sheet. No dividends ever paid.

(11) Interest paid currently.

(12) Interest paid at less than stated rate, but no accumulations. $1,266,000 owned by Rio Grande and pledged with RFC (v. n. 5).

(13) 50,000 shares of no par value, shown at amount stated on balance sheet. No dividends ever paid.

(14) Held by RFC as shown in n. 5.

(15) Owned by Rio Grande and pledged with RFC as shown in n. 5. Properties operated under lease by Rio Grande, which receives all revenues from such operation.

APPENDIX D

RIO GRANDE BONDS

Total Claims as of January 1, 1943

	Principal	Unpaid Interest	Total Claim
OUTSTANDING			
G. W. Trust 4's	$ 15,190,000	$ 4,860,800	$ 20,050,800
G. W. Consol 4's	15,080,000	4,976,400	20,056,400
G. J. 5's	2,000,000	758,333	2,758,333*
& R. G. Consol 4's	34,125,000	11,602,500	45,727,500
& R. G. Consol 4½'s	6,382,000	2,441,115	8,823,115
& R. G. Consol 4's and 4½'s	$ 40,507,000	$ 14,043,615	$ 54,550,615
& R. G. W. R&I 5's	12,000,000	4,950,000	16,950,000
& R. G. W. R&I 6's	2,000,000	990,000	2,990,000
& R. G. W. R&I 5's and 6's	$ 14,000,000	$ 5,940,000	$ 19,940,000
& R. G. W. Gen 5's	29,808,000	13,740,155	43,548,155
PLEDGED			
RFC			
R. G. W. Trust 4's	10,000	3,200	13,200
R. G. W. Consol 4's	1,395,000	460,350	1,855,350
& R. G. Consol 4's	783,000	266,220	1,049,220
& R. G. W. R&I 5's	4,385,000	1,808,813	6,193,813
Total RFC	$ 6,573,000	$ 2,538,583	$ 9,111,583
R. C. C.			
& R. G. Consol 4's	662,000	225,080	887,080
Chase Bank			
& R. G. W. R&I 5's	6,096,000	2,514,600	8,610,600
OUTSTANDING AND PLEDGED			
R. G. W. Trust 4's	15,200,000	4,864,000	20,064,000
R. G. W. Consol 4's	16,475,000	5,436,750	21,911,750
R. G. J. 5's	2,000,000	758,333	2,758,333*
& R. G. Consol 4's	35,570,000	12,093,800	47,663,800
& R. G. Consol 4½'s	6,382,000	2,441,115	8,823,115
& R. G. Consol 4's and 4½'s	$ 41,952,000	$ 14,534,915	$ 56,486,915
& R. G. W. R&I 5's	22,481,000	9,273,413	31,754,413
& R. G. W. R&I 6's	2,000,000	990,000	2,990,000
& R. G. W. R&I 5's and 6's	$ 24,481,000	$ 10,263,413	$ 34,744,413
& R. G. W. Gen 5's	29,808,000	13,740,155	43,548,155
Total			$179,513,566

*Purchased later by Debtor Trustees.

App. E, F. 1

APPENDIX E

RIO GRANDE

NEW CAPITALIZATION UNDER PLAN (WITHOUT CONSOLIDATION)

Title of Issue	PRESENTLY TO BE ISSUED			To be Outstanding (1)	Annual Requirements
	To be Publicly Held	To be Pledged as Collateral	Total		
Equipment Trust Obligations	5,758,000		5,758,000(2)	5,758,000(2)	139,989 (2)
First Mortgage Bonds (3)	31,249,764	3,090,922(4)	34,340,686	32,816,610	1,030,220
Total Fixed Interest					1,170,209
Contingent interest on First Mortgage Bonds (5)					343,407
First Mortgage Sinking Fund					171,703
Total requirements before Second Mortgage Interest					1,685,319
Chase Bank Note				2,158,458	
Second Mortgage Bonds (6)	20,415,162	2,361,148(7)	22,776,310	21,803,312	1,024,934 (8)
Second Mortgage Sinking Fund					56,941
Total debt and requirements before Preferred Dividends				62,536,380	2,767,194
Preferred Stock (9)	32,120,120	5,076,089(10)	37,196,209	35,301,877	1,859,810(11)
Total requirements before Common Dividends					4,627,004
Common Stock (12)	35,167,585	8,081,104(13)	43,248,689	39,029,495	
Total Capitalization (excluding securities for Junction Bonds)	124,710,631	18,609,263	143,319,894	136,867,752	

NOTES TO APPENDIX E

(1) Includes RFC collateral, since the escrow agreement is not to be enforceable except through the collateral, but excludes Chase Bank collateral, since the note is to be enforceable as such.

(2) See n. 1 to Appendix C. Bear interest at 3¼%, 3% and 2%. Due serially 1946-1954.

(3) Bear fixed interest at 3% and prior contingent interest at 1%. Due 1993.

(4) $1,566,846 under escrow agreement with RFC and $1,524,076 under note to Chase Bank.

(5) No deduction is made for the Capital Fund since roadway depreciation under the accounting requirements effective from January 1, 1943, will apparently be charged in such amounts as to eliminate any obligation to the Capital Fund (see Rio Grande Annual Report 1943 p. 4).

(6) Bear contingent interest at 4½%. Due 2018.

(7) $1,388,150 under escrow agreement with RFC and $972,998 under note to Chase Bank.

(8) Of this amount $18,410 represents interest on Chase Bank collateral in excess of interest on the note and thus applicable under the Plan to the reduction of the principal of the note. Excluded from tax-deductions in Appendix F.

(9) 5% Preferred stock of the par value of $100 per share.

(10) $3,181,757 under escrow agreement with RFC and $1,894,332 under note to Chase Bank.

(11) All Preferred dividends on Chase Bank collateral ($94,717) are in excess of interest on the note and are thus applicable to reduction of its principal.

(12) Par value $100 per share.

(13) $3,861,910 under escrow agreement with RFC and $4,219,194 under note to Chase Bank.

NOTES TO APPENDIX F

As reported. The Salt Lake is omitted from this table; its inclusion would make no significant change in the results. The table includes the Junction Company and the Salt Lake Western, as well as all operations of the Rio Grande over the Salt Lake line pursuant to the Trackage Agreement.

The reported net available for interest on funded debt plus (*i*) reported Federal income tax accruals, (*ii*) reported interest on unfunded debt, and (*iii*) the increases to project the lower 1940 unit costs of operation back through the earlier years of the proceeding (see Ex. 262, R. 1133), eliminating inter-company items with the Junction Company and the Salt Lake Western, and including the accounting adjustments shown in Report of Bureau of Accounts. The increases per Ex. 262 are: 1936, $1,709,096; 1937, $3,625,147; 1938, $2,422,599; 1939, $1,131,428; total, $8,888,240. To include these increases, as the table does, increases the net earnings and thus favors the General Mortgage Trustee.

Federal income taxes are computed at 35% on the earnings shown in Column 2 after interest payable under the Plan, excluding all interest on equipment obligations.

The deductions are interest on the new bonds (excluding equipment obligations and securities for Junction Bonds), requirements for Capital Fund (before 1943 only) and Preferred Dividends at 5%. No deductions are made for sinking fund installments.

The only deduction made in this column is dividends at 6% on the new Common Stock.

This column adds back all the Federal income taxes deducted in Column 3 and thus shows what would be the result if there were no Federal income tax at all.

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APPENDIX F

RIO GRANDE EARNINGS APPLIED UNDER PLAN

	1	2	3	4	5	6
	Gross Revenues (1)	Earnings Available for Income Taxes and Return (2)	Net Earnings After Income Taxes @ 35% Available for Interest and Dividends Under Plan (3)	Balance After Preferred Dividends (4)	Balance After Common Dividends @ 6%	Col. 3 If There Were No Federal Income Tax
1921	32,621,419	3,753,175	3,272,617	d 1,735,754	d 4,330,676	d 3,850,11
1922	33,350,594	5,645,978	4,502,939	d 505,432	d 3,100,354	d 1,957,31
1923	34,587,497	3,317,573	2,989,476	d 2,018,895	d 4,613,817	d 4,285,72
1924	33,011,558	3,029,479	2,802,214	d 2,206,157	d 4,801,079	d 4,573,81
1925	33,629,463	7,229,249	5,532,065	523,694	d 2,071,228	d 374,04
1926	34,030,309	8,347,110	6,258,675	1,250,304	d 1,344,618	743,81
1927	33,121,169	6,995,895	5,380,385	372,014	d 2,222,908	d 607,39
1928	33,200,656	7,767,286	5,881,789	873,418	d 1,721,504	163,99
1929	34,828,669	9,309,932	6,884,509	1,876,138	d 718,784	1,706,63
1930	29,747,537	6,841,186	5,279,824	277,765	d 2,317,157	d 755,79
1931	23,484,818	5,312,095	4,285,915	d 559,576	d 3,154,498	d 2,128,31
1932	17,560,621	2,984,207	2,772,788	d 1,924,598	d 4,519,520	d 4,308,10
1933	17,112,794	3,456,210	3,079,590	d 1,696,601	d 4,201,523	d 3,824,90
1934	19,246,850	2,594,675	2,519,592	d 2,219,950	d 4,814,872	d 4,739,78
1935	20,944,230	2,559,571	2,496,774	d 2,285,087	d 4,880,009	d 4,817,21
1936	25,599,309	3,470,282	3,088,736	d 1,809,618	d 4,404,540	d 4,022,99
1937	26,781,992	3,538,826	3,133,290	d 1,794,631	d 4,389,553	d 3,984,01
1938	23,404,171	2,745,954	2,617,923	d 2,225,552	d 4,820,474	d 4,692,44
1939	25,073,039	3,137,948	2,872,719	d 2,012,478	d 4,607,400	d 4,342,17
1940	26,219,195	2,920,513	2,731,387	d 2,182,464	d 4,777,386	d 4,588,26
1941	31,572,624	4,655,209	3,858,939	d 1,149,432	d 3,744,354	d 2,948,08
1942	54,475,496	19,209,045	13,318,932	8,310,561	5,715,639	11,605,75
1943	70,194,002	18,699,441	12,987,690	8,729,319	6,134,397	11,846,14
1944	70,346,987	13,949,384	9,900,153	5,641,782	3,046,860	7,096,99
Total	784,144,999	151,470,223	118,448,921	1,618,770	d60,659,358	d27,638,05

d indicates red figure

APPENDIX G

When-Issued Prices Under the Plan

PRICES*

	1945	
	High	*Low*
First 3s-4s 1993	103½	90¼
Income 4½s 2018	79⅞	67¼
Preferred Stock	67⅝	53½
Common Stock	31½	23½

REALIZATION**

	% of total claim on basis of	
	High	*Low*
Western Trusts	97.2%	84.2%
Western Consols	67.5%	54.2%
Eastern Consols	65.1%	54.7%
R. & I.'s	57.7%	46.9%

*Monthly closing prices from Bank and Quotation Record, published by Commercial and Financial Chronicle.

**The new securities allotted in the Plan to each old bond are taken at the indicated prices and their total is then expressed as a percentage of principal and interest on that bond to the stated effective date of the Plan on January 1, 1943.